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Quarterly Commentary

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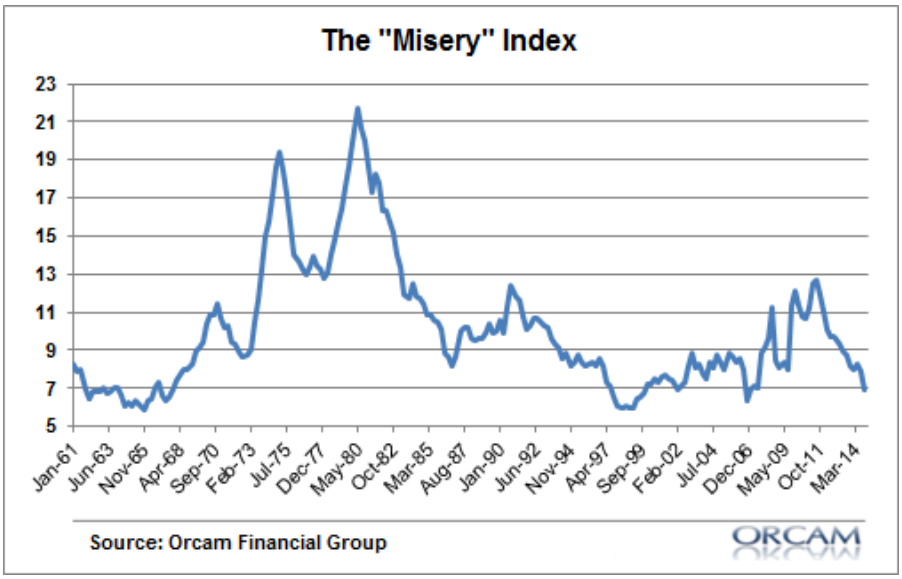
The Coming End of the Malaise

You probably read the above caption hoping we were going to have some insight as to when that might happen. Unfortunately, that is beyond our pay grade. Though we do not know when, we do believe that the end will come.

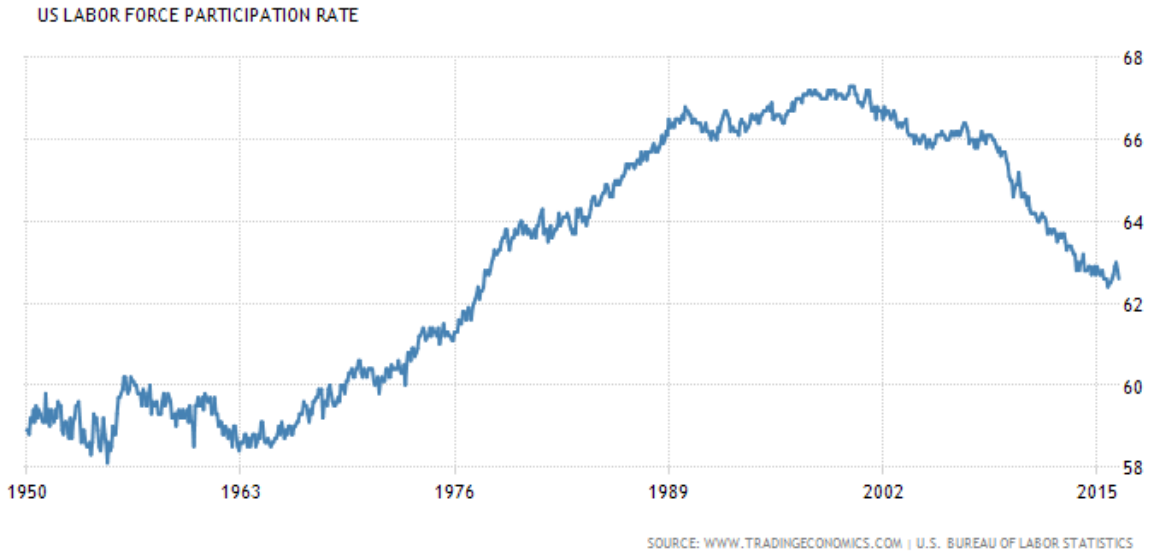
One is currently reminded of the malaise of 1979-1980. Inflation was at double digit levels and interest rates were too. The country was in the midst of the Iranian hostage crisis, which lasted 444 days. Economic growth was sputtering back and forth between small positive and negative quarterly numbers. The misery index, a statistic derived by adding the unemployment rate to the inflation rate of the Consumer Price Index (CPI), stood at an all-time high (see graph below). The country was still wobbly from its experience in Vietnam and the resignation of Nixon from the presidency amid scandal. There existed a general lack of optimism among the populace that the economy and standards of living in general would get much better.



Historians and politicians have and probably will argue about what finally turned things around. No doubt the end of the hostage crisis gave people's spirits a lift. However, the two key things from our point of

view that triggered the end of the malaise were a cut in the marginal income tax rates for individuals and the beginning of the introduction of computers and related technology into everyday life. In 1979 it was hard to foresee that either of these things would happen, so downtrodden was the populace. What has followed has been a tremendous expansion of wealth, productivity and overall living standards.

Today, there also seems to be a general uneasiness in the air, and rightfully so. Economic growth is similar to that in 1979-1980. While the misery index is much lower than it was at that time, there are two items that may be making it appear lower than it really is. Primarily, the fall in the labor participation rate (see nearby graph), we believe, is masking the true rate of unemployment, as discouraged workers drop out of the work force. Also, while the Consumer Price Index continues to assure the masses that there is not a whiff of inflation anywhere, prices of most asset classes trade at above-average long-term valuation levels.



Adding to the misery, our young graduates of the last decade have had tremendous difficulty in obtaining challenging and rewarding opportunities in many fields of endeavor, causing particular dissatisfaction among that group with the "establishment" and a general hesitancy to put down permanent roots. The lowest interest rates on record have scared the bejeebies out of those at or near the point of needing to rely on their nest egg for their standard of living. Fiscal policy gridlock is producing federal government budget deficits as far as the eye can see, and the Federal Reserve Bank has chosen to use radical monetary policy as the sole tool to try to produce economic growth to make up for the lack of effectiveness on the fiscal policy side. Finally, protectionism has been winked at, if not embraced, by both of the presumptive nominees for President in an effort to capitalize on people's fears (more on this later).

The malaise exists in Europe as well, and it could be argued that it had its origins there. The recent vote by the British to leave the European Union (EU), while no doubt containing some

anti-immigration element, was primarily, we believe, a statement that the rank and file is disgusted and frustrated with the status quo.

Hopefully you are not too depressed to continue reading, because we think what lies ahead contains, albeit unidentifiable at present, the remedy for the current malaise.

We always believe that it is human nature for man to strive for a higher standard of living. At some point the aforementioned problems will become so burdensome that a solution or a way around these problems will be tried, and eventually progress will continue.

A very successful investor and client of ours recently sent us a blog posting to read that we found fascinating. To summarize, most of us think linearly and do not comprehend (because most tend to be too focused on the short-term) the pace at which epochal change is happening. Because man's progress and knowledge is cumulative, as that base expands, the pace of change grows exponentially. As an example, consider human progress achieved in the last 100 years. Most would agree that it at least equals or exceeds that achieved throughout recorded history up to that time (1916). Again, we tend to not think about what that holds for the future and how we perceive change because we tend to emphasize the here and now. To access the article referenced and related articles mentioned in it, go to: http://goo.gl/RI19eh

One does not have to look very far to see epochal change occurring. Exploration and commercialization of outer space is expanding rapidly as the private sector assumes a larger role. In medicine, treatments are advancing that will continue to improve lives for the better. Biologic drug development has produced a cure for Hepatitis C in the last couple of years and has introduced an entire new weapon in the field of oncology in treating specific cancers through the immune system. Though controversial from an ethical standpoint, editing of the human genome may make it possible to avoid hereditary problems in future generations. In the field of energy production and development, it has taken less than ten years to go from an outlook of scarcity to one of abundance. These are just a few examples of progress that were inconceivable not that long ago.

The article's conclusion based on the world's incessant march toward progress is to get fully invested and stay fully invested in the best companies, regardless of valuation. For us, the investment thesis in all of this **is not** what the author of the aforementioned article suggests. The stock market in 1979-1980 was very inexpensive by any measure, especially compared to today. In the last several years, investors have been encouraged and, in some cases, forced to take risk in the stock market because fixed income markets offer almost nothing in the way of yield. The lesson from the article, we believe, is that it is human nature to over-emphasize current conditions and extrapolate them into the future. Because the future is unforeseeable and unknown, assuming that present conditions will continue gives one confidence about what lies ahead (good or bad). We must realize that change is inevitable. That is why we believe the current malaise will come to an end even though it seems so entrenched at present. We believe it's just a matter of time.

Protectionism and Politics

While none of us are trained economists, we've done our share of studying and reading on the subject of international trade. When it comes to economics, we have our opinions (our spouses would say that would be true of any topic). The winds of protectionism are blowing. One of the presumptive nominees for president has actually proposed tariffs on Chinese and Mexican made goods. The other candidate has recently voiced opposition to the Trans-Pacific Partnership trade agreement that seeks to break down barriers to trade among twelve countries (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States and Vietnam). President Obama is seeking ratification of the agreement.

In our opinion, the Great Depression resulted from the Great Stock Market Crash, a huge increase in the marginal income tax rates and the Smoot-Hawley Tariff, which was passed into law in June of 1930. You might have also read that the Federal Reserve helped cause the depression by not providing sufficient liquidity to the banking system during that time. We tend to view that more as an error of omission as opposed to an error of commission, understandable, given that the Fed had only been in existence since the end of 1913.

Even if you accept that the Smoot-Hawley Tariff was not the largest contributor to the Great Depression, which is debatable, the fact that the world's largest economy imposed such large restrictions and taxes on trade obviously helped make the depression a global phenomenon.

We believe international trade is vital for the world economy and individual economies to maximize their potential. We also believe that business commerce between nations fosters an environment that makes the world a little more of a shared space, improving relationships between countries.

Some of the world's most complex challenges are in the area of breaking down barriers to free and fair trade that already exist. We define fair trade as a condition where producers are not in receipt of special treatment and are on equal footing whereby the most cost efficient producer has the competitive advantage.

Many industries considered vital to a country's national interest (e.g. agriculture, steel, defense) often receive subsidies, tariff protections, import quotas or other preferential treatments that penalize the most cost efficient producer. In some countries, governments themselves own the factors of production. Thus, fair trade is more of an optimizing theoretical goal than a reality. Invariably, special interests have injected themselves politically into the equation. There is always the temptation for politicians to "help" certain constituencies. It takes real leadership, especially in a democracy, to keep the world moving in the direction of free and fair trade.

Because we have the most advanced and largest economy in the world, the U.S. probably has the most aggrieved industries when it comes to unfair trade practices. Examples abound of

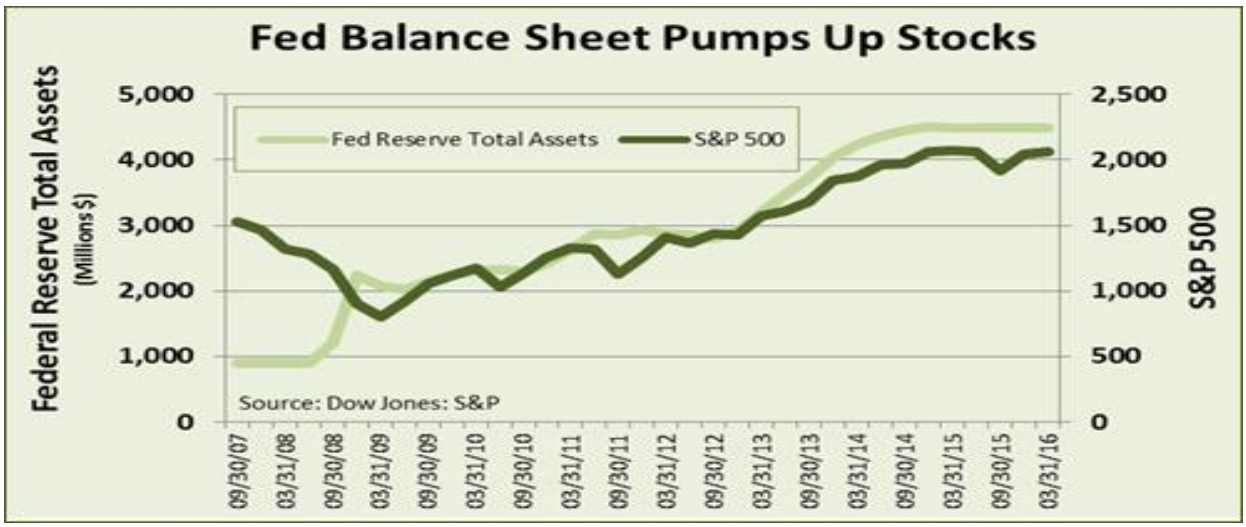
highly subsidized dumping of foreign-made products into world markets. Obviously the country harmed by unfair trade practices loses industry and jobs, adding to the pressure for retaliation.

In the end, countries that isolate themselves end up doing harm to their own economies. One only has to look at the extreme examples such as Cuba and North Korea to see how well an isolated economy (isolated for whatever reason) performs for its people.

We recently came across a quote from American economist Henry George (1839-1897) that made a lot of sense to us. "Trade is not invasion. It does not involve aggression on one side and resistance on the other, but mutual consent and gratification. There cannot be a trade unless the parties to it agree. If foreigners will bring us goods cheaper than we can make them ourselves, we shall be the gainers."

To repeat, the issues surrounding international trade can become highly complex and highly emotional very quickly. These issues impact people's lives and livelihoods in various ways. Hopefully, world leaders will continue to work toward free and fair trade and break down existing barriers so that markets will determine winners and losers. We believe all people of the world will be better for it.

The (Stock) Market Economy



Unlike the central banks of Japan and Switzerland, our Federal Reserve Bank has not resorted to the direct purchase of public common stocks in the market (yet). However, we recently saw the nearby graph of the S&P 500 and the Federal Reserve's total assets since the Fed began buying bonds aggressively and using every other trick in the book to bring down interest rates. We'll leave it to you to decide whether there is any correlation between that activity and the prices in the stock market.

Value vs. Growth

You will recall from last quarter's commentary that we have been in a stock market where growth stocks have out-performed the value universe for most of the last nine years. The last five years have been particularly difficult for value investors. We are finally getting some respite from that in the first six months of this year, as value has out-performed growth by almost 5%. While it is way too soon to declare victory, our performance has turned upward even more, as is usually the case when value is doing well. We are grateful for the change in trend.