October 8, 2018

ECONOMY BOOMING

Dear Investor:

The economy is booming right now. We logged in at 4.2% in the second quarter. Estimates for the third quarter range from around 2.3% to 4.1%. Most everyone is expecting the Christmas retail season to be good due to very low unemployment and strong consumer spending. While it's definitely too early to say, we have a good chance of showing growth over 3% for 2018. According to my research, the last time we grew at 3% or more was in 2005. Our total GDP is over $19 trillion dollars and may pass $20 trillion by the end of the year. The Euro zone growth rate for 2018 is projected to be 2.2% and Japan may be able to hit 1.0%. We are doing well compared to these other mature economies. It's taken a long time, but it looks like low rates and now tax cuts have done their job. So, where do we go from here?

We know the Fed has been raising rates for almost three years now. We've had a total of eight increases, and it's likely we will end 2018 with number nine. As I've mentioned in the past, it appears the economy has been able to absorb these increases thus far without any issues. Right now, the Fed wants to get short rates up to what they call the "neutral rate". This is the rate which they believe is neither stimulating the economy nor holding it back. As you would expect, this is not an exact science. There are different opinions on what the neutral rate is. To be brief on this, the generally accepted range for the neutral rate is around 3% to 3.5% at this time. We are still well below that range, so you can understand why the Fed is predicating more increases to come in December of this year and in 2019. Some of the Fed Governors believe that after a few more increases, it will likely make sense to pause and get a better grip on the outlook. I'm in agreement with that, as we are entering a new phase in this current expansion and bull market.

During the month of September, there were many articles written and TV interviews shown on the "ten year anniversary of the crisis". This was due to the fact that it was in September of 2008, that Lehman Brothers, the fourth largest investment bank in the US, filed for bankruptcy. It was the largest bankruptcy filing in the history of the US. As you may know, the crisis started much earlier in late 2007 with problems emerging at other institutions, but Lehman going down was considered to be the defining moment by many. Just for the record, at one time, Lehman Brothers was not only a banking powerhouse, but was considered one of the classiest players on Wall St. They had a tremendous reputation. That they were destroyed by taking on too much risk is a lesson for all of us to remember.

Along with the commentary on the crisis, people naturally had their own predictions as to what our next crisis would be. These ideas covered a wide range of issues and scenarios that could get out of hand and cause us big problems. There are way too many to discuss in a short letter like this. If there was one issue that was mentioned by almost everyone, it is the enormous amount of debt that still exists in the world today. Central Banks have created somewhere around $22 trillion in the last decade to help produce this recovery. Most of this "money" is still on their balance sheets. No one performed any labor to earn this money. It's been created out of thin air. This is against a total world GDP in the range of $80 trillion. What this will mean for us over the long term remains to be seen. History shows us that governments that print too much money and borrow too much money do not have a good ending. In the private markets, low quality debt with very little protection for investors is at an all-time high. This was another area of concern by many because credit is being handed out like candy in some parts of the market. When things turn down, a lot of this will not be paid back.

I'm bringing this up, because somewhere up the road we know we will enter another recession. I want to stress the point that what happened in 2008 and overlapping into 2009, was not a "normal" cyclical recession. What we went through at that time was truly a crisis, as we were essentially faced with a collapse of the banking system. While every bank certainly did not have the problems of Lehman and others, the contagion could have spread like an uncontrollable wildfire that would have shut down the whole system. Many people believe that would have thrown us into a depression similar to, or worse than, the 1930's. I think that was a very real possibility. FDIC data shows that over 500 banks failed in the 7 year period from 2008 through 2015. In the 7 years that preceded the Great Recession, only 25 banks failed. That's what happens when you make too many bad loans. You can get a glimpse of what might have happened without the Fed and the Treasury backing up the system.

Expansion and recession have always been considered normal parts of the business cycle. A recession is actually defined as two or more consecutive quarters of negative GDP growth. So thus, a recession could be as short as six months. In the time period since World War 2, the average recession has lasted around 11 months. Expansions eventually slow down for several reasons. The one you hear the most often is rising interest rates. This brings us back to the Fed and their interest rate policy. As expansions pick up steam, there generally comes a point where inflation also picks up momentum due to higher spending, rising prices and rising wages. The Fed cannot allow this to spiral out of control. This leads them to put their foot on the brakes by continuing to raise interest rates. Eventually those higher rates lead to a significant decline in economic activity. This decline will show up in the data with slowing GDP growth, rising unemployment, slower retail sales, etc. Thus, we have a recession. My hope is that our next recession will just be a normal cyclical recession. We will certainly not abandon our long term investment program at that time.

Please contact me anytime to discuss your portfolio.

Best Regards,

David E. Keim

Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is no guarantee of future results.

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