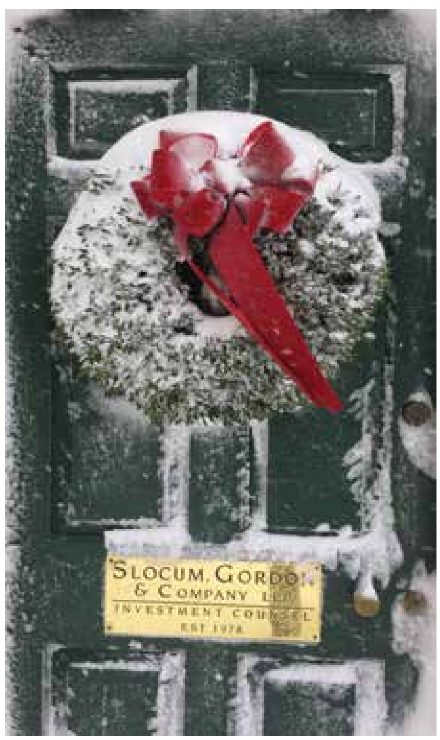
SLOCUM, GORDON & CO. LLP
INVESTMENT COUNSEL • EST 1978

JANUARY 1, 2018

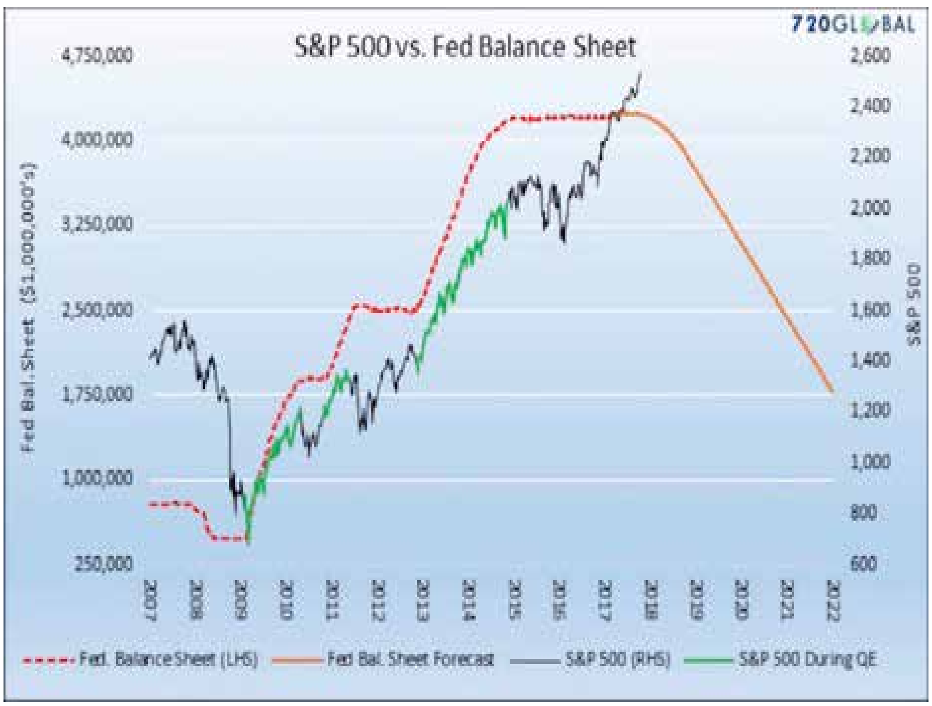
VIEWPOINTS

The world of stocks and bonds is a complicated place. Professionals can spend a lifetime trying to understand the dynamics that impact prices of stocks and the direction of interest rates. Is it an art or a science? If it were easy, everyone would be a millionaire!



As long term investors, we look at the world a bit differently than the typical Wall Street "talking heads" who regularly appear on the various cable TV business programs. The instantaneous news flow and the short term, quarter-to-quarter corporate earnings releases that are highlighted in non-stop broadcasts 24-hours a day can be distractions to the true investor. Conversely, we regard investment management as a long-term effort to protect and enhance our clients' capital by making investments within narrowly defined risk parameters in companies with which we are familiar enough to want to be co-owners of the business. As co-owners, we expect to share in increasing profits and dividends which over the long term are important contributors to the overall total return from our investment.

Markets have life cycles just like everything else, and there are times when defined investment styles lead and others lag. This past year is an excellent example when a select number of large capitalization technology companies affectionately known as FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) led the markets' voracious appetite for growth stocks at the expense of so-called value stocks that typically are more seasoned, dividend-payers. Relative valuations of the former now appear extremely expensive while the latter seem to offer bargains. Since we are not momentum investors (speculators), when the market seems to be running on adrenalin as it has in 2017, we prefer to look for out-of-favor companies that have good long-term prospects at a price that the market has yet to recognize. As the sage of Wall Street, Benjamin Graham, once wrote: “The essence of investment management is the management of risks, not the management of returns.”



The typical factors—other than expected mean reversion—that would accompany a severe downturn for the most part are not yet present, and stocks can certainly go higher in this momentum environment we are in. However, there are a number of issues we want to examine, if only to be as prepared as possible for changes in the landscape and to keep expectations in check.

We have said since the onset of the Great Recession that we were in uncharted waters with respect to the Federal Reserve’s monetary policy of targeting near-zero interest rates by buying enormous amounts of debt instruments for its own portfolio. The more recent Fed intention of raising short term interest rates while simultaneously reducing its bloated balance sheet is without precedent in history, and it remains to be seen how that can be accomplished with minimal impact on the wider economy and stock market.

The adjacent chart is the S&P 500 Index overlaid with the Federal Reserve’s balance sheet and the forecast of where the Fed intends to take its balance sheet.

The Fed and other central banks have essentially persuaded investors into risk assets since 2008 which can been seen in the green segments of the S&P 500’s rise concurrent with the Fed’s quantitative easing programs (red line).

That tailwind that has pushed stock prices higher over the last 8 years is now turning into a headwind. The Fed has provided a schedule by which it will unwind its balance sheet, and this chart might offer a sense of the *potential* direction in the S&P 500 *if* the Fed unwinds as planned and *if* the relationship between liquidity and stock prices persists.

The recently passed tax legislation has given a boost to already rich stock prices on the basis that the tax savings will stimulate the economy. Time will tell how effective that will be, but the stock market has had time to largely discount these benefits in underlying stock prices.

With respect to valuations, most sectors of the stock market are one or two standard deviations above average, and according to Prof. Robert Shiller of Yale, the cyclically adjusted price to earnings ratio (CAPE), as shown on this next chart has only been higher twice in history: briefly in 1929 and the dot-com bubble between 1997 and 2001. This is a particularly good metric because it is based on 10-year actual trends. Future 5-year returns with the CAPE near current levels have historically been limited to mid-single-digits.

Looking ahead, our view on the interest rate front has consistently been "lower for longer" and we still hold that view. Demographic headwinds, excess capacity, and deflationary global and technological competition (robotics) argue for more of the same for longer term bonds. Inflation has the largest impact on long term rates, and in our view, inflation will not be an issue for some time yet. This is an unconventional view, but so far it has not been proven wrong. Income remains our central focus in our investment strategy, and we continue to tread carefully in a market that is now priced to perfection.

Meanwhile, here on Mill Street, we have reached our milestone 40th anniversary of our founding in 1978. We remain extremely grateful for the confidence our clients have expressed in our firm, and we look forward to another productive year on your behalf.

We are very focused on protecting the sensitive and confidential nature of our clients' information, and we are enclosing our privacy statement in our year-end mailing. Finally, in compliance with Rule 204-3 (c) of the Investment Advisers Act of 1940, we are making our annual offer to send you our current brochure.

With our best wishes for a prosperous New Year.