February 12, 2016

Dear clients and friends,

Welcome to another bear market. The S&P 500 has declined by approximately 13% from the all-time high it hit last July. But that's only a part of the story since the S&P is weighted most heavily in mega-cap names like Google and Amazon, which have held up better than most. The Russell 2000 (the small cap index) and the MSCI EAFE (international index) have both fallen by over 20% since July.

A Real Mess

I'm worried. That, of course, is why you hired me in the first place – to do the worrying for you. It is in markets like this that advisers can truly earn our keep. (When markets are rising, being a financial advisor is much easier!) I'm not losing sleep over the fact that we're in a bear market. Ugly markets are nothing new to me. During the market declines in 1990, 1997, 2000, and even 2008, I felt a cleansing – as if lower prices were wiping out the excesses and creating some compelling buying opportunities. Today, however, I have a different feeling – an uneasy feeling.

For starters, the US stock market remains above a level that would suggest compelling value across the board. While some pockets of value are appearing, the valuation of the broad market (S&P 500) remains high by historic standards. Though cheaper, stocks today are like a sale at Bergdorf's: less expensive, but no bargain. This means that US equities, as a group, offer less upside potential in terms of real returns (above inflation). Furthermore, there are secular changes afoot that deeply disturb me.

Promises, Promises

So many promises from so many governments. They've compounded ever since the 1950's – promises of minimum incomes, housing, medical care, economic stability. Making unrealistic long-term promises is easy. Honoring them is not. Citizens are now lining up to collect on the benefits promised them in sunnier times. Plenty has been written on the subject of under-funded government entitlement programs, so I won't repeat it here. Suffice to say, the math simply does not work.

What can government do? Defaulting on these promises is not politically feasible. Borrowing more money is hardly an option either. Governments are now burdened with debt far exceeding levels leading up to the 2008 financial crisis. Raising taxes is a realistic alternative, yet even the most progressive economists realize that this alone will not get them out of the hole. One notoriously expedient solution is for governments to inflate their way out of their obligations. On cue, central bankers the world over have thus embarked on a race to debase their currencies. This is nothing new under the sun. Kings throughout the ages have fallen to the temptation to create new money to pay their debts or fight their wars.

So far we've only tasted the sweet sugar rush of the inflation. To the surprise of many, especially me, central bankers have perfectly executed an asset inflation with negligible consumer price inflation. Their secret? By pressing interest rates to zero, they orchestrated a cost of capital so low that almost any new capital investment project was worthwhile. Hence, companies and builders embarked on adding new capacity that would have been uneconomic during normal times. This new supply has kept consumer price inflation in check.

Getting back to "normal" means that today's artificially low interest rates must be allowed to revert to their natural, higher levels. As the cost of capital rises, a lot of existing capacity will become uneconomic and need to be shuttered. That will be a headwind to economic growth and employment. Central bankers know this and realize they're painted into a corner. Investors finally realize that the world's central planners are not quite as "in control" as initially presumed.

Buckle Up

No one can predict exactly how things will play out. All we can know for sure is this: There is no easy path back to normal. Governments globally will likely choose politically easier fixes rather than tougher, but healthier, long-term fixes. This means governments will be even more activist going forward. Two of the most likely tools in their arsenal will be price controls and capital controls. The most important price in our economy, interest rates (the price of money), has long been under government control. Now central bankers are adopting more aggressive price distortions: going from zero to *negative* interest rates. This is Twilight Zone stuff. Soon you may actually have to pay your bank or broker for the privilege of depositing (lending them) your money. Some banks' customers already are. This Financial Repression is unjust to savers, it retards economic growth, and it destabilizes society. Yet, it is the "easy" way out politically for governments to nominally meet their promises to entitlement recipients and creditors. And of course, they'll likely raise taxes as well.

Faced with these kinds of assaults, folks will naturally seek to move their money to more hospitable environments. And this is why capital controls have been introduced (or tightened) in several counties, including China. It's not unthinkable that they could one day be used here. Historically, the track record of price and capital controls is abysmal. They wreck economies. Even though central bankers learn this in school, they continue to resort to them when faced with no other (easy) solutions.

If in fact central bankers do choose this path, what can we know? Only this: Real economic growth will decline, volatility will increase (in economic activity as well as in consumer and asset prices), and the long-term buying power of currency will erode. History teaches that there are consequences to currency debasement and price controls. Things become more volatile. Some prices inflate, some deflate. As the old adage goes, inflation and deflation are two sides of the same coin — the same debased coin. This volatility introduces uncertainty, which weighs on confidence, and thus on economic growth. Buckle your seatbelt, folks. There's a bumpier road ahead for markets, prices, and social order.

<u>The Best Defense</u>

Ironically, the best way to protect yourself against this pessimistic outlook is to adopt an optimist's attitude. Yes, there is an assault coming upon owners of capital. Your best defense, though, is a strong offense. If you adopt the defensive strategy of a pessimist, putting your money under a mattress, you'll ultimately find that it buys far less when you pull it out years later. Instead, you should adopt the offensive strategy of an optimist. Aim to *own* the greatest quality income-producing assets you can. Wake up each day hunting for great things. This means shares of great companies run by great people (if you can buy them at good/great prices). These could be public or private businesses. It could also mean great income-producing real estate. The key here is to "own it" – having real equity in things you understand. Done properly, you'll wake up years later still owning the same shares of the same (or better) earnings stream in real terms. Between now and then, the market price of your shares will have fluctuated – at times violently. But in the end, you'll likely have preserved your relative wealth and buying power. At best, you'll have grown it in real terms.

In the latest Berkshire Hathaway annual letter published last spring, Warren Buffett practically begs us to buy stocks (the broad S&P 500 even). Think about that. Stocks were even more expensive when he wrote this. Why would the world's shrewdest, most successful investor recommend buying stocks at those highs? He explains that stocks are one of the best ways for investors to protect their long-term purchasing power. Buffett, who is incredibly careful with his words, doesn't come out and explicitly say that currency debasement is government's most likely "Hail Mary" play, but that's how I read his meaning between the lines.

Rest assured, we do not mean to imply that a strong defense is not important. It goes hand in hand with playing a strong offense. Indeed, we have been carrying higher than normal levels of cash and fixed income in client accounts. This is dry powder that gives us buying power when stocks periodically get cheap. This "option value" of cash is, in our judgement, worth quite a lot more than many realize. Don't let the near-zero interest rates fool you. With the market's recent pull-back, this cash gives us the ability to begin building positions in some compelling values that we are now seeing in some foreign markets, as well as certain types of US stocks.

In summary, we at Fielder believe your best defense will be a strong offense. That means we're taking an optimist's attitude in forging through the pessimistic days likely before us. Please know how seriously we take the role to which you've entrusted us. This is not an easy road to navigate. Our best course of action is to have a written investment policy customized for your situation and stick to it over time. As always, please always feel free to reach out for any reason. I'm here for you.

Sincerely,

Frank Byrd, CFA