

WOODSTOCK

QUARTERLY NEWSLETTER

Spring, 2016

How important is growth to the US economy and our economic well-being? From 1950 to 2000 the US economy grew at an average rate of 3.5% per year. Since 2000, it has grown at half that rate, 1.7%.¹ During this time period, the author points out, real GDP per person has risen from \$16,000 in 1952 to over \$50,000 today, both measured in 2009 dollars. If the US economy had grown at only 2% from 1950 then real GDP per person would be \$23,000 in 2000, he says, ready to keep growing at a reduced rate to the present. In alluding to the importance of a growth strategy for the US economy, Senator Richard Burr of North Carolina and the Senate Finance Committee speaking to an industry group in Washington DC in April of 2015 catalogued the economic budgetary issues facing the country and said that a 4% growth rate solves those problems. Also, Mr. Cochrane describes the effects of a 3.5% growth rate for US GDP, even with no structural reforms, as increasing GDP by 38% by 2040, increasing tax revenues by 38% and budgetary problems “would go away on their own”. He goes on to describe a “general strategy for growth” involving changes to ten major sectors or influences on the economy. One of the ten, finance, covers regulations and a prescription. “In 2008, regulations did not fail for being absent. Regulations failed for being ineffective.” The prescription is: “risky investments must be largely financed by issuing equity, not by borrowing very short term money. When that happens, the mass of regulations is simply not needed in order to stop financial crises.” The unsettled and dangerous times we live in do seem to be of our own making. A conscious effort to stimulate growth might be a solution.

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Beyond investment management, the broader financial advice we provide to some of our clients deals with a comprehensive look at their assets, liabilities, budgeting and financial goals. Many of our clients inhabit complex financial structures. One part of those structures is usually tax-benefited retirement plans. For many years it has been the assumption in financial planning that contributions to those plans should always be maximized. In 2014, the Senate Finance Committee chairman commissioned a study by the GAO on super-sized IRAs.² Using 2011 data, out of over 43 million tax returns reporting IRAs, 630,000 had assets of over \$1 million and 9,000 had assets of over \$5 million. Proposed changes at the time included asset class disclosure, limiting stretch features to five years, prohibiting contributions if over certain limits, at that time only limited changes were made. However, with a “tax cost” of over \$140 billion per year, revenue raisers only need imagination and a belief in the greater good to absolve themselves of the shame of breaking promises. For some investors, using taxable accounts invested in growth stocks for a portion of their long term planning assets as a hedge against potential tax changes to large retirement accounts would be worth considering. It may be trusting too much in human nature to have an outsized percent of long-term planning assets in tax-benefited accounts. A prominent Boston Trust attorney addressing the Federal Tax Institute in Boston 30 years ago advised his audience to strive to keep reporting to government agencies to a minimum by utilizing tax and gift strategies that limit or eliminate reporting to government agencies. In the future their clients would appreciate it.³

Besides the market gyrations at the start of the year, we also went through a client custody conversion to Fidelity. Our experience, as always subject to your review, is that the conversion process overall went well. Anticipating that the end result will be better for our clients and ourselves, the immediate concern was that assets transferred February 29, 2016 arrived safely on March 1, 2016, which did occur. If any of you want help cross walking from the last SEI statement on February 29th to the beginning balances on the first monthly statement from Fidelity, please let us know.

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this bull market owes something to monetary authorities' willingness to intervene. Authorities have not allowed the market to explore the cheaper side of valuations. As a result, neither investors nor business managers have the confidence of knowing where we are in the business cycle. They do not have confidence of where the economy and market values would be in the absence of monetary intervention. The uncertainty may be disorienting, thwarting forward progress.

Bonds are all the more propped up by central bank actions. According to Janus Capital Bond Fund Manager Bill Gross, as much as 40% of bonds in Europe were recently trading at negative interest rates² – lenders paying borrowers for the privilege of lending. Buying bonds at negative interest rates could only make sense if the buyer were anticipating further market intervention – finding a “greater fool.” US Treasuries yields have been driven lower by their value relative to other sovereign debt, with the 10-Year closing down 0.50 percentage points during the quarter to 1.77%.

We believe stocks remain the most attractive asset class and are poised to outperform bonds and cash. Shareholders are earning dividend yields higher than most bond yields, and earnings are likely to grow. The S&P 500 Index is trading at a modest premium to its historical trading range, finishing the quarter trading at 17.2x forward earnings, compared to a 20-year average of 16.3x. P/E ratios can remain above their long term average for multiyear periods, and probably will given the low interest rate backdrop.

Moreover, investors may be anticipating a recovery in some of the more beaten down sectors (energy, materials, and industrials) such that S&P 500 earnings could be understated and the index's P/E multiple could therefore be overstated. The worst of the downdraft in energy and commodity prices appears to be behind us. Even if they don't recover sharply, as Tom argued they should in our Winter 2015 newsletter, stable energy and commodity prices will remove one headwind to S&P earnings growth.

The US Dollar's strength also appears to be moderating, removing another headwind to earnings growth. Finally, economies around the world, from Europe to Japan to China, have also been showing weak growth for some time now. If they recover, that too could boost earnings growth from here.

However, stocks may be susceptible to bond prices – lower bond prices are likely to have some impact on stock prices and the economy – but the modest premium to their historical average notwithstanding, stocks in general aren't notably overvalued. The thought of having a rate increase cycle in which the Federal Open Market Committee raises rates 17 times seems unfathomable now. Not that we expect that many rate increases either, but, the thought experiment shows how little confidence investors have in the economic environment. There's quite a bit of room for confidence to recover. The Fed needs to be able to implement 0.25 percentage point rate increases without the stock market going haywire. Maybe it starts with the Fed not feeling they need to react to every downdraft in the market. We are hopeful that investors' confidence in our economic prospects can build from here.

It is the nature of markets to be off-balance, shifting from one extreme to the other. Maybe the markets themselves will rebel against those seeking to impose order – the central banks. It's hard to say if the market's next attempt at defiance will be to the upside or the downside. The answer could be either, or both – something has been left unfinished both on the downside and the upside. Underlying the ever-present risks of market volatility, the economy also seems well-grounded. At Woodstock, we strive to navigate the tumult while staying invested in quality stocks for the long haul, and this is – as most times are – a very good time to stay invested. ♦

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¹Based on data dating back to 1871 from Dr. Robert J. Shiller. www.econ.yale.edu/~shiller/

²Gross, William, Janus Capital Group Investment Outlook, “Sunshine, Lollipops and...” March 2016.

The detailed work of making sure that the basis for tax lots is accurate was mostly completed in March. The methods and procedures for making disbursements from client accounts have changed. We're gradually populating the information and approval repositories that Fidelity requires for normal transfers, but remember that fast track wire transfers are always available for a fee. Investment managers and operations staff at Woodstock Services have worked very hard over these few months and we believe that benefits of the conversion will prove to be worth it.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest.

William H. Darling
Chairman & President

Adrian G. Davies, CFA
Executive Vice President

¹ Cochrane, John H. Hoover Institution, Stanford University October 27, 2015

² WSJ Tax Report, 10/6/2014

³ Please contact your investment manager for the reference

Who Killed the Business Cycle?

Adrian G. Davies

It is an interesting fact that the bull market is now 7 years old, making it the fifth longest in US market history. On that basis, it's reasonable for investors to argue that we are past due for a bear market. The average bull market has lasted 4.6 years, and the longest on record is 12.7 years.¹ To make these determinations, a bull market is defined as a trough to peak period interrupted by no more than a 20% downturn. The current bull market was down 19% at one point in 2011 – had it been down one more point, it would have reset the clock for a new bull market. Earlier this year, the market was down more than 13% and off to its worst start to a year ever, and then recovered to close the quarter fairly flat, returning +0.8% for the quarter and -0.4% over the prior year before dividends. If the old bull is reset after a 20% downdraft, it gets no rejuvenation from being down 13%, demonstrating that these statistics are generated by somewhat arbitrary parameters. Using this methodology, we can't definitively say if we're currently in a bull market or not. The S&P 500 Index hit an all-time high of 2,131 in May 2015. If the market falls 20% below this high before achieving a new high, then the long bull will have ended in May 2015 at 6 years, 2 months.

Rather than trying to determine where we are from reading the tape, we ought to consider how to position portfolios tactically

based on where we are in the business cycle. The headline unemployment numbers support the view that we are in the mature stage of an economic expansion. The unemployment rate for March was 5.0%, toward the lower end of its historical range, and the economy has added an average of 246,000 jobs per month over the last six months. These strong numbers suggest the economy is at a greater risk of overheating than underachieving. However, a number of market pundits and economists take the view that the headline unemployment rate does not reflect a fair representation of labor conditions. They cite the underemployment rate (9.8%) which adds part-time workers and those who have stopped actively looking for work to those seeking full-time employment. Another often cited statistic is the labor participation rate (63.0%), which is also weaker than it has been in the past. Underemployment has bullish implications for the market because it implies there is underutilized capacity suggesting upside potential and minimal inflationary pressures driven by wages. Recessions are less often caused by a dithering economy than by overheating, which drives the Fed to raise interest rates, while compelling business managers to build out too much production capacity and too much inventory, using too much debt.

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More importantly, low GDP growth rates don't seem to support the view that the economy is particularly strong. GDP growth has been bumping along in the range of 1.5%-2.5% since the Great Recession, anemic by historical standards. The economy grew 0.5% in the first quarter of 2016. The Institute of Supply Management's Purchasing Managers' Index contracted for the five months through February before showing expansion again in March. The difference between the strong employment numbers and the modest GDP numbers over the past few years is probably best explained by weak productivity, something Tom Stakem highlighted in our Spring 2015 newsletter.

Fear of the next recession itself may have helped to prolong the current economic expansion. The analog for the stock market is that after two approximately 50% sell-offs in 2000-2003 and 2007-2009, many investors remain very cautious. Corporate managers may be underinvesting in their businesses for similar reasons. There hasn't been an investment boom. There may be pockets of speculative excess (in, say, private equity), but nothing on the scale of the technology bubble of 2000 or the housing bubble of 2006. As a country, we aren't making stupid investments - at least it doesn't feel like we are.

The stock market is not currently rife with "animal spirits." Both the market tops of 2000 and 2007 were accompanied by a Federal Reserve which was hiking interest rates. Recall that the Federal Open Market Committee raised the Federal Funds rate 17 times in 0.25 percentage point increments during the last interest rate cycle ten years ago. The Fed and most market participants had confidence that the economy could withstand such a steep increase in rates. Today, the Fed is inclined to raise rates from 0.37% at the short end of the yield curve, having made one 0.25 percentage point increase in December. In March, Federal Reserve officials revised down their forecasts of how much they expect to raise rates this year. They haven't raised rates meaningfully because inflation remains quiescent and GDP growth modest. The headline Consumer Price Index was +0.9% year-on-year in March.

They may also be more sensitive to stock

market action than they have been in past cycles. As previously mentioned, the stock market fell 13% from November into February. Economic reports weren't particularly strong either, so it's unclear whether the Fed was reacting to market or economic conditions when they reduced their own projections for rate increases in March. The Fed and the stock market repeated a cycle evident in August through October 2015 when the market started to weaken and the Fed responded with more relaxed monetary policy, postponing a well-telegraphed rate increase at its September meeting. The market responded to the monetary encouragement with a rally which gathered steam through October, just as it did this past March.

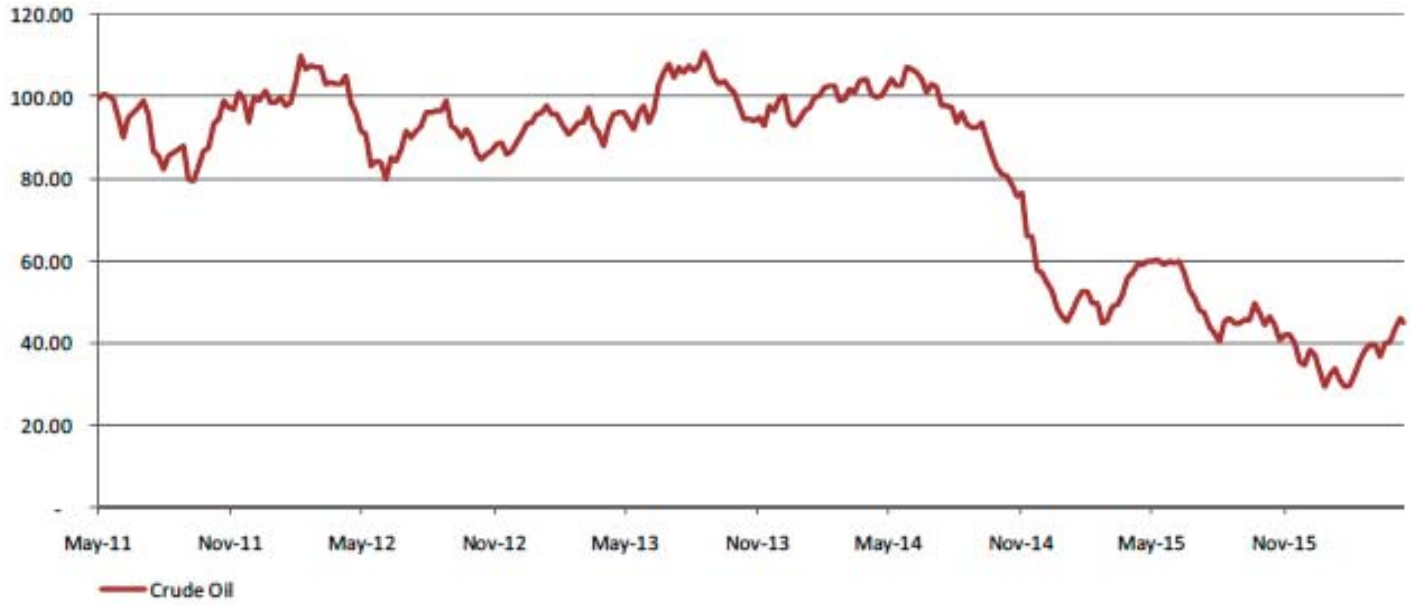
Other central banks are going to even further extremes in order to support the world's capital markets. Bank of Japan Governor Haruhiko Kuroda cut interest rates into negative territory for the first time in January, easing monetary policy further despite already having a program in place to buy ¥80 trillion in securities a year. While European Central Bank President Mario Draghi had hinted in January that the ECB would announce new easing measures, markets were nonetheless surprised in March when the bank cut interest rates even deeper into negative territory and expanded the continent's quantitative easing program from buying €60 billion in securities a month to €80 billion.

These are not signs of a thriving global economy. The monetary actions show how worried central bankers collectively are about the next recession or at least deflation. With inflation so low, central banks can afford to err on the side of increasing inflation rather than to err on the side of not easing. But they may be the macroeconomic equivalent of helicopter parents. While the general thinking is that the monetary actions are helping their economies, the actions belie a lack of confidence in economies' abilities to right themselves. So far, monetary actions have stopped the markets' slides. Investors have reflexively jumped into stocks knowing that monetary actions drive stocks higher. Your accounts have benefited.

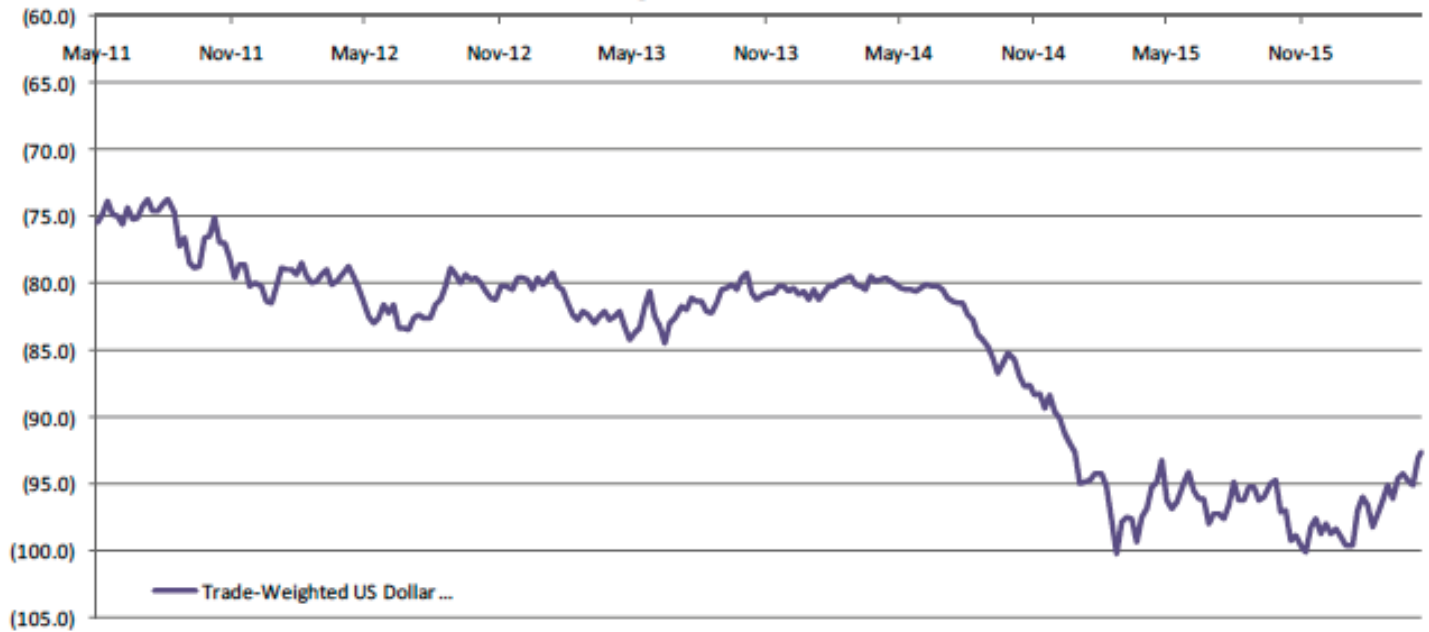
The very proactive central banks have disrupted the typical business cycle. The duration of

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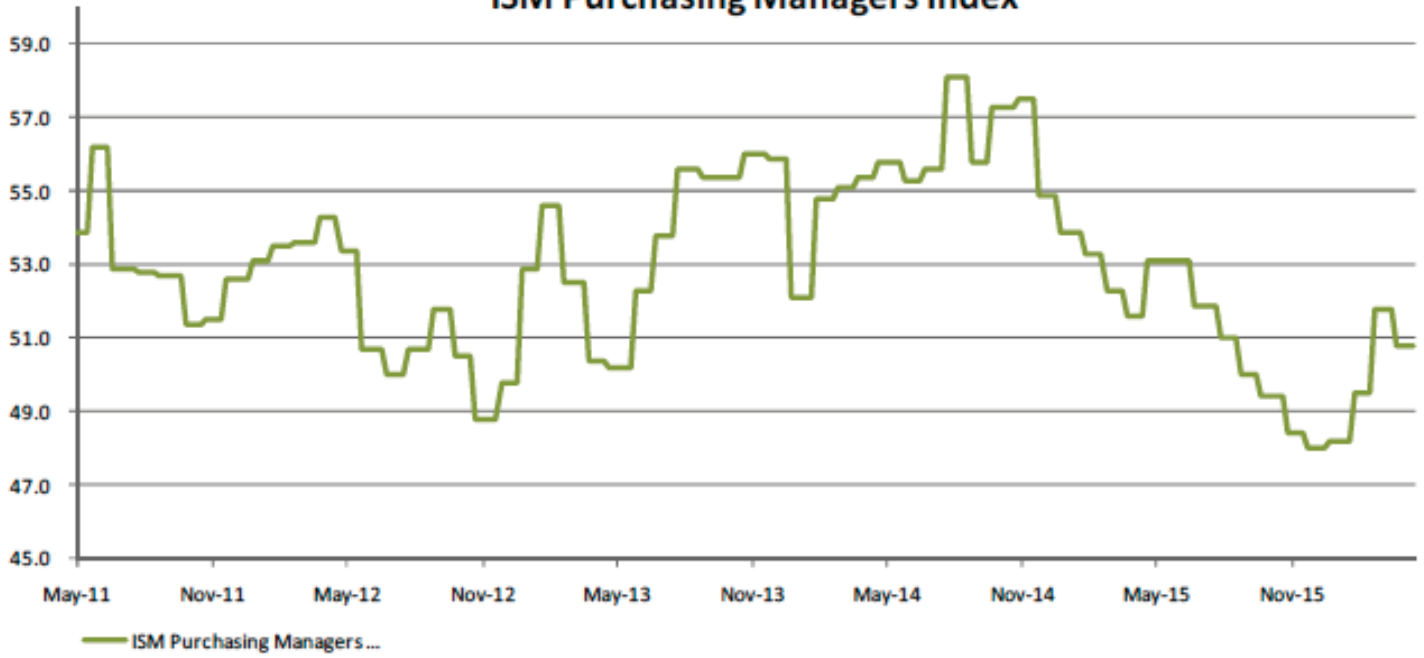
Crude Oil



Trade-Weighted US Dollar (Inverted)



ISM Purchasing Managers Index



US 10 Year Treasury Yield

