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Re: Investment Advisory Letter

If you have ever binge-watched a dramatic television series or read an engrossing novel, you probably know all too well that a great storyline will keep you engaged. Compelling plot lines can hold one's attention from sunset to sunrise, seeking answers to the question "what happens next." We continually ask ourselves similar questions regarding specific companies in your portfolio, the markets, the economy and even politics.

In this latest **Investment Advisory Letter**, we will provide you with our outlook regarding the "what happens next" questions pertaining to future economic growth, our national debt, inflation, interest rates, market valuations and government entitlements. Our outlook presented in this letter represents some of the most important assumptions we make when implementing your portfolio's investment strategy. As a result, we hope this letter will help you better understand the investment decisions we make on your behalf as well as convey what we believe is a realistic, long-term perspective for your portfolio.

Our Long-term Economic Story

From the turn of this century to the present day, our economy has more than doubled in size from $9.63 trillion to $20.65 trillion. Even adjusted for inflation, our economy is now about 43% larger compared to the beginning of this century.[1] What is remarkable about this growth is that it was achieved during periods of significant uncertainty and economic stress, including terrorist attacks on September 11, 2001, a multi-year military response to these attacks and a severe financial crisis.

In addition to more than doubling the size of the economy, we have seen even faster growth in government debt. So far this century, our national debt has risen 350% to $21.65 trillion,[2] a pace much faster than the 124% in total economic growth during this same period. If we compare on an inflation adjusted basis our current debt load at the beginning of this century to our total economic growth, our national debt has grown by about 158% compared to 43% in total economic growth.[3,4] There are many causes for this rapid increase in debt, such as: the ongoing war on terrorism; record government spending measures to avert a depression following the 2008 financial crisis; and a lack of political will to make much needed spending reforms.

The rise in debt has not been limited to just the federal government. Corporations (excluding banks and other financial companies) have more than doubled their debt loads since the beginning of 2000 to approximately $6.2 trillion today.[5] This figure pales in comparison to total mortgage and consumer debt of about $19 trillion.[6] If we add corporate, consumer and mortgage debt to the $21.65 trillion in federal debt and an additional $3.85 trillion in local government debts,[7] the economy is currently carrying over $50 trillion in debt (a figure which is over twice its size).

While total debt levels across the economy have increased, total loan servicing costs (the interest paid on our nation's debt) have so far been manageable, thanks in part to low interest rates and strong economic growth of over 3% per year.[8] Low interest rates have been made possible by low inflation rates of just over 2% a year on average since the beginning of 2000.[9] Low inflation is due in part to increasing productivity gains of about 2% per year since 2000 and to global competition.[10] The "what happens next" question is, will the economy slow or decline due to the increasing debt loads? In our view, the economic risk of higher debt levels will grow over time. However, these high debt levels do not present an immediate risk to the economy, especially in today's low interest rate environment.

Our Inflation Outlook

Even with record low unemployment, our outlook for inflation remains subdued due in part to the following: low labor participation rates of about 62.9% compared to 67% in early 2000;[11] the trend towards more automation, which we believe will only accelerate in the years ahead; and global competition. In our view, the economy has plenty of "surplus" labor to keep wages and inflation in check. Increasing labor participation from 62.9% to 65%, for example, would be the equivalent of adding over 5 million U.S. citizens to the workforce who are currently not working but who are eligible to work.[12]

While the economy has the labor supply, employers along with the federal and local governments should offer additional financial incentives and training to bring more citizens into the workforce. Our expectation is that with over 6.9 million job vacancies in the U.S.,[13] we expect financial incentives and training opportunities to increase over time to fill many of these vacancies. This increased labor participation should in turn help curb inflationary trends, and thus help keep interest rates low.

A Tipping Point in Healthcare

Despite our optimistic outlook for low core inflation, we expect continued high inflation rates in the healthcare sector. In our opinion, the primary causes for high inflation rates in this sector are due to a combination of these four factors: 1.) increased government spending; 2.) increasing demand for healthcare from an aging population; 3.) a lack of competition; and 4.) insufficient increases in supply to meet the growing demand for healthcare. [A recipe for higher inflation is more dollars chasing the same finite resources.] Without the political will to reduce government spending in healthcare and without the promotion of policies to increase competition, the hidden tax of inflation within healthcare is expected to persist at a rate far above core inflation. To quote the economist Milton Friedman, *"Inflation is one form of taxation that can be imposed without legislation."*

The growing economic divide between the top 10% of our population as measured by income compared to the remaining 90% helps fuel more populism, tribalism and socialism.[14] If you combine these societal trends with the increasing demand for healthcare from an aging population with historically low savings rates and the growing cost of healthcare (fueled in part by government spending), a “tipping point” may be reached in which our country rejects the current system. A possible outcome could be a worst-case scenario in which the government effectively assumes control of the healthcare sector through any number of measures, including a reduction of patent protections on drugs and medical devices; the requirement of a single payer system; and price controls. This is not an unthinkable scenario given the role governments play in healthcare in other modern economies.

The current healthcare system, which is a hybrid of capitalism and socialism, appears to be moving more towards socialism. In our view, over the next 10 to 15 years the probability of significant government intervention increases if this sector, which currently represents about 18% of economic activity (compared to just over 6% in 1970), grows to over 20% to 22% of economic activity.[15] As a result, there may come a time in which the political risks of investing in healthcare become too high, which could lead us to sharply reduce our healthcare exposure. At least at this time, we remain cautiously optimistic that our worst-case scenario is not a foregone conclusion, as other options exist to curb rampant healthcare spending. These options include efficiency gains from technology, modernizing the patent system, increased competition and entitlement cuts (discussed later in this letter).

Our Outlook for Interest Rates

While long-term rates as measured by the 10 Year U.S. Treasury Bond yield have risen from 2.34% to 3.22% over the last year,[16] interest rates remain at historically low levels. Even if rates were to move up quickly from 3.22% to above 4.0%, our outlook is for a continuing trend of falling long-term interest rates. Our expectation is that this trend, which began over 35 years ago, will continue due to:

1. Increasing demand for fixed income payments from the growing population of retirees buying government and corporate bonds;
2. Significant productivity gains from automation, which can help reduce inflation;
3. A pool of surplus labor that keeps inflation under control (as previously discussed);
4. The expectation that the U.S. dollar will continue to be the world’s reserve currency; and
5. The continued “safe haven” status of our bond market for foreign investors (especially during periods of significant economic and political distress).

If this outlook proves correct, lower interest rates should continue to help support higher market valuations for stocks in the years ahead.

Our Market Outlook

At least over the short-term, we expect trade tensions and economic rivalries between nations (such as the U.S. versus China) will continue to rise, most likely resulting in periods of increased market volatility. While we do not believe markets can be timed, significant market selloffs due to trading disputes or other causes could create long-term buying opportunities for your portfolio. This outlook is based on an expectation that globalism driven by capitalism will ultimately prevail over protectionism and populism. While a multi-year period of negative returns is always a possibility for equities, our current outlook for U.S. equity returns over the next 10 to 15 years remains positive and above core inflation. We do, however, expect returns for U.S. equities to be below the 8.9% average annual returns achieved over the previous 15 years.[17,18]

Our dampened market outlook of lower future returns is based partly on current market valuations. As U.S. stock prices have risen in value, future return potential has declined. Market valuations remain above historical averages as measured by long-term market ratios including the Shiller Price to Earnings Ratio (Shiller P/E Ratio) and the Market Cap to GDP Ratio. The Shiller P/E Ratio is currently at 31.5 compared to a historical average of 16.9,[19] and the Market Cap to GDP Ratio is currently at 140.6% (ratio figures between 75% and 90% are considered to be fairly valued by historical standards).[20] Short-term market valuation ratios are also high by historical standards, including the market's current price to earnings ratio of 22.7.[21] [A price-to-earnings ratio of 22.7 indicates that investors today are willing to pay $22.70 for $1 of earnings compared to an historical average of $15.73 for $1 of earnings.]

Please note that none of the market ratios previously mentioned have any predictive value for future market gains or losses. These ratio averages also cover periods in which interest rates were significantly higher compared to today, as well as multiple recessions. Nevertheless, all three ratios indicate that returns may be much lower in the years ahead due to today's market valuations. At current levels, these ratios also indicate to us that many investors are still paying full prices, if not substantial premiums, for a majority of U.S. equities, especially for many high-flying growth stocks.

Similar to what we saw in the late 1990s, broad market index funds (e.g. an S&P 500 index fund) and ETF-only equity strategies may be particularly vulnerable to the risk of a broad, prolonged market selloff. Such strategies can involve broad market exposure, including an over-allocation to some of the most expensive stocks in the market. For example, 23% of the S&P 500 index is comprised of technology stocks, which is the heaviest allocation of the 11 sectors that make up this index. The second largest allocation is healthcare at 14.96%. These two sectors represent almost 40% of this market tracking index for large U.S. stocks. In addition, these two sectors represent some of the highest valuations at over 30 times earnings on average compared to 22.7 times earnings on average for the entire index.[22,23]

The Next Chapter

As we turn to the next chapter in our economic story, we expect rising federal and local government debt levels will become the primary arc of our story within the next 10 years. If history is any guide, rising consumer and corporate debt levels will also eventually create some significant economic challenges.

While low interest rates have helped reduce the cost to our nation of racking up record levels of debt,[24] the cost of servicing this debt is expected to rise to over $900 billion within the next 10 years. Since the government is expected to continue to borrow and spend more than it collects in taxes, the interest payments required to service our debt could eventually exceed what is currently spent each year on the military, Medicare and Social Security.[25,26] If left unchecked, rising debt levels could also result in debt payments that eventually "crowd out" much needed expenditures such as infrastructure spending. This financial scenario could lead to significant cuts in entitlement spending such as Medicare and Social Security. We believe the odds of such an outcome increase over time due to:

1. Current demographic trends driven primarily by an increasing number of baby boomers entering into their retirement years, thus increasing the demand for more entitlements;
2. Increased economic and military rivalries between nations, which could drive more military spending at the expense of future entitlements and infrastructure spending;
3. The increasing role of government spending in critical sectors of our economy including healthcare and education, which help drive a vicious cycle of more inflation within these sectors as well as more debt; and
4. Rising debt servicing costs.

While the trend towards higher debt levels continues to be a growing concern, debt servicing costs are currently manageable for an economy of our size that is growing at over 3% per year. As a result, unless the economy were to decline sharply and unexpectedly, we do not expect current debt levels to present significant near term challenges to the economy or equity markets. Additionally, we do not expect government debt levels to impede economic growth over the next 2 years, especially if new debt is used for much needed infrastructure spending, which could foster future economic growth.

Under the most extreme conditions, the ultimate power in our economic system is not the government, but our financial markets. When the financial markets dictate policy and outcomes (as they did in the 2008 financial crisis), the end result can be painful and unpopular legislative decisions that are bipartisan in nature and previously unimaginable. In addition, excessive debt burdens can lead to significant economic consequences including a severe economic contraction. In our view, the probability of this scenario increases over time given the economy's growing debt burden.

The cliffhanger in our economic story may be how the government ultimately responds to a period in which the market has either lost its appetite for buying more debt and/or the economy is in a period of decline due to excessive debt burdens. Faced with similar choices in the past, previous governments have succumbed to the temptation of printing more money to pay back debt, which can be highly inflationary. As the consequences of rampant money printing can be as dire as default, we expect future policy makers will heed the hard lessons of the past and not go down such a disastrous path. We do, however, expect higher tax rates and promises to be broken, especially those relating to Medicare and other government entitlements - the money is simply not there to keep these promises.

With over $4 trillion in unfunded local government pension liabilities, we also expect promises to be broken at the local level as a growing number of local municipalities around the nation have insufficient funds to meet their growing pension obligations.[27,28] To quote Alexander Hamilton, *"The contracts between a nation and individuals are only binding on the conscience of the sovereign, and have no pretensions to a compulsive force."*

> [A few words of caution on real estate: If you own or are considering buying real estate in an area of the country with significantly underfunded pension plans for local government employees, please give careful consideration to property taxes. We would expect in most cases for property taxes to rise to help meet underfunded pensions. Higher property taxes could in turn: reduce the property's value; increase your holding cost each year; make the property harder to sell; and reduce your expected returns.]

Summary

For the fixed income buyer, higher interest rates are providing more attractive yield opportunities as compared to previous years. However, the previously discussed high equity market valuations create additional downside risk for the equity portion of your portfolio, especially if an unexpected event were to occur (e.g. a severe economic contraction). In addition, a period of rising long-term interest rates can make equities less attractive as bonds compete with equities for your investment dollars. In addition, rising interest rates can result in short-term losses for current bond holdings as prices typically decline in response to rising rates. As this price risk is most significant for long-term bonds, our current strategy emphasizes short to intermediate term bonds for the fixed income portion of your portfolio.

As long as we are long-term buyers of equities with sufficient funds held outside of the market to meet spending needs, we should welcome down markets. Such conditions can create buying opportunities, because we need the markets to sometimes "go on sale" in order to find good bargains. From a historical perspective, a period of flat to negative returns across the equity markets that lasts at least three to five years would not be unusual. As a result, maintaining sufficient exposure to other asset classes (such as fixed income) is a wise path forward, especially if you are already retired or within ten years of retirement.

Since the future is always uncertain, we recommend you have at least 7 to 10 years of spending money held outside of the stock market. Similar to earthquakes occurring in nature, the timing, exact location and severity of market earthquakes are not predictable. As a result, it pays to plan ahead for the unexpected. To quote former British Prime Minister Winston Churchill, "*Let our advance worrying become advance thinking and planning.*" In our view, most of the funds you may need for both expected and unexpected spending should be held in short to intermediate-term government and corporate bonds. If you need help determining how much to allocate to fixed income investments (based on your spending needs) or have any other questions or concerns, please don't hesitate to call us.

Like any great story, our economic story will always be full of subplots, plenty of drama and cliffhangers. We have seen in just a short period since the November 2016 election, the stock market reach new highs followed by sharp selloffs, record low unemployment combined with low labor participation rates, growing trade tensions, and increasing polarization and populism both here and abroad. As our story continues, the proverbial "what happens next" question will be: "Will the economy prosper, or is it on the verge of an economic contraction?" From the vantage point of the long-term investor, short-term performance should be of little relevance. Looking beyond the short-term however, we expect there will be periods of economic contraction and other challenges, some of which are self-inflicted (e.g. excessive debt levels and entitlements). Despite these challenges, we also expect the economy and our markets to overcome these challenges and prosper over the long-term.

Thank you very much for being our client. Your trust and confidence are truly appreciated.

Sincerely,

Matt

Matthew Goff
Chief Investment Officer

P.S. As a friendly reminder, if you have any funds under our management that you plan on spending within the next two years, please call us. Depending upon what you are currently invested in and in which account, we may advise you to transfer these funds to a credit union or online bank that offers higher yields with little to no price risk or management fees. We always want to do what is in your best interest. Under certain market conditions, the best course of action may be to consider other options independent of our management. We are here to provide advice and support regarding these other options as needed.

cc Nick Lyons, Financial Advisor
Rick Peterson, CIMA®, Financial Advisor

End Notes:

[1] The Bureau of Economic Analysis www.bea.gov/
[2] US Treasury www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm
[3] Bureau of Labor Statistics data.bls.gov
[4] US Treasury www.treasurydirect.gov
[5] Board of Governors of the Federal Reserve System (US) fred.stlouisfed.org
[6] Board of Governors of the Federal Reserve System (US) www.federalreserve.gov
[7] Reuters money.usnews.com/investing/news/articles/2018-11-02/us-municipal-bond-market-struggles-to-find-footing
[8] Gross Domestic Product (GDP): The Bureau of Economic Analysis www.bea.gov/data/gdp/gross-domestic-product
[9] US Bureau of Labor Statistics data.bls.gov
[10] Labor and Manufacturing Productivity Gains as reported by Bureau of Labor Statistics
[11] Trading Economics and US Bureau of Labor Statistics tradingeconomics.com/united-states/labor-force-participation-rate
[12] The Balance www.thebalance.com/labor-force-participation-rate-formula-and-examples-3305805
[13] Organization for Economic Co-operation and Development alfred.stlouisfed.org
[14] U.S. Real Weekly Wages: US Bureau of Labor Statistics
[15] Kaiser Family Foundation analysis of data from OECD (2017), "OECD Health Data: Health expenditure and financing: Health expenditure indicators", OECD Health Statistics (database) www.healthsystemtracker.org/chart-collection/health-spending-u-s-compare-countries/#item-since-1980-gap-widened-u-s-health-spending-countries
[16] 10 Year Treasury Rate from YCharts ycharts.com/indicators/10_year_treasury_rate
[17] Morningstar: S&P 500 Total Return Index
[18] The average return is for the S&P 500 market index and does not represent the performance of any specific portfolio under our management.
[19] Shiller P/E Ratio www.gurufocus.com/shiller-PE.php
[20] Market Cap to GDP ratio www.gurufocus.com/stock-market-valuations.php
[21] S&P 500 Price to Earnings Ratio, trailing 12 months earnings
[22] Morningstar: S&P 500 www.morningstar.com/
[23] Sector Valuation: Shiller P/E Ratios by Sectors www.gurufocus.com/sector_shiller_pe.php
[24] Congressional Budget Office www.cbo.gov/
[25] National Priorities Project: Military spending in the US www.nationalpriorities.org/campaigns/military-spending-united-states/
[26] “As Debt Rises, the Government Will Soon Spend More on Interest Than on the Military” New York Times, September 25, 2018 www.nytimes.com/2018/09/25/business/economy/us-government-debt-interest.html
[27] “Fed Accounting Change Boosts Unfunded Pension Obligations”, Bloomberg, September 27, 2018 https://www.bloomberg.com/news/articles/2018-09-27/fed-accounting-change-boosts-unfunded-pension-obligations-chart
[28] “When the City Goes Broke: Pensions, Retirees, and Municipal Bankruptcies” Congressional Research Service, Kevin M. Lewis, April 10, 2018 https://fas.org/sgp/crs/misc/LSB10116.pdf

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