EAST COAST
ASSET MANAGEMENT

Q2 2017 Investment Review

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The Mountain is high, the valley is low and you're confused on which way to go
So I've come here to give you a hand and lead you into the Promised Land, so
Come on and take a free ride (free ride)

Free Ride, The Edgar Winter Group, August 1973

For what seems to be forever, the financial markets have been vexed by historically high valuations of stocks and maddeningly low yields of bonds. As an example, the July 14th, 2016 *Wall Street Journal* headline proclaimed *"A World Turned Upside Down."* That year ago phenomenon is still the status quo for investors. As of the end of this June, benchmark global stock market indices had posted another solid quarterly performance, with many finishing just a notch below all-time highs, and US bond yields had fallen - again. As the chart below also highlights, crude oil saw further declines and gold paused its recent run-up.

Benchmark Index Returns

	S&P 500	MSCI All Country World	MSCI Emerging Markets	MSCI EAFE	Bloomberg-Barclays Aggregate Bond	Gold $/Troy Oz.	Crude Oil $/bbl.
Q2 2017	3.1%	4.3%	6.3%	6.1%	1.4%	-0.5%	-9.0%
Q1 2017	6.1%	7.0%	11.5%	7.4%	0.8%	8.4%	-5.8%

The US Federal Reserve voted to increase the fed funds rate again in June, the fourth incremental increase of 0.25% since the current tightening cycle began in December of 2015. Investors have justifiably turned attention back to the Fed recently because history suggests that periods when the Fed has sustained multiple rate increases (a "cycle"), have often coincided with recessions. More attention had been paid to proposed legislative actions over the past several months to gain insight into the future path of economic and financial indicators. Fed actions tend to act with a delay, six months or more by many estimates. The Fed nudging rates from zero to 1% may not seem like much, but it is a beginning and the cumulative effect may now be on the horizon. The Fed has pointed to strong employment data to support their actions, whereas inflationary data seems less clear.

Even with the Fed's tightening, the 10 year US treasury yield was 2.30% at the end of June, down from 2.39% in March. That meager sum is far better than the German equivalent of 0.47%. At this time last year, the newly issued German government 10 year bond traded with a negative yield for several months between June and October - hence the context supporting the WSJ's "*Upside Down"* headline. These low rates have been a consistent factor that many point to for the relentless advance in global stocks over the

past several years. With some bellwether European countries showing economic strength (notably Germany), the European Central Bank has been talking up the case for starting its own rate increases. As of June, this had not occurred and European stocks have performed quite well year-to-date. With high stock prices and low bond yields, deciding which way to go with new investments continues to be a challenging exercise. We are mindful not to be caught in the trap of yes/no logic as if there are only two possible answers, or options; is it high or is it low? Is it value or growth? Our Investment Committee work simultaneously emphasizes the integration of multi disciplinary thinking about business trends and security valuations, as well as the integration of the best of Eastern and Western thought to provide context to our analyses. There don't appear to be any "free" rides in sight for quality-minded, value-oriented investors, like ourselves, but we are seeing the potential for a third way to view the current state of affairs.

- **The current interest rate cycle may persist at low rates for quite some time due to very low inflation expectations**
- **If so, stock valuations should be viewed as fairly valued, or even attractive**

One key element to the discussion about future values is estimating the right inflation rate. As we have written in the past, bond yields are determined by several factors, but perhaps the most important is the *expectation* for future inflation. What is the future worth? What will a dollar be worth in five years, or ten? Economics textbooks tell us that inflation is a sustained increase in the price level of goods and services and thus an erosion in the purchasing value of money. But what if, due to the effects of the Digital Revolution and the relentless pursuit of quality enhancements among the providers of goods and services, the value of your dollar appreciates over time? This would be deflationary. If the data used by the financial markets to form expectations about future inflation/bond yields is faulty, then the output of that thinking is likely to be faulty. Another interpretation of inflation data may signal that we are in an environment in which low rates linger for quite a while. If that is the case, the present value of future earnings may be quite reasonable - even cheap.

The bond market keys off of inflation data to price bonds, among other issues, since a traditional bond represents a fixed rate of return before the effects of inflation. Holders of bonds, all else equal, will want to be paid back a positive rate of return knowing that - historically - the value of a dollar erodes over time. But the stock market also keys off of this inflation number. Partially this is due to the need to discount future earnings with an appropriate rate (some version of bond yields) but also due to the need to evaluate how assets employed and inventories held in a business will depreciate rapidly or slowly. It may not be an overstatement to say that the single data point of inflation, and by extension the expectations for future inflation, is the most important number to grasp for investing.

The discussion about inflation is largely governed by data collected by two principal entities; the Bureau of Labor Statistics (BLS) that oversees the Consumer Price Index (CPI) and the Bureau of Economic

Analysis (BEA) that oversees the Personal Consumer Expenditure series (PCE). The apparatus and methodology for calculating CPI goes back to the 1920s, when understanding steel production inputs, along with other industrial indicators, were rising or falling. Now, however, we have entered the Digital Revolution. Though steel production no longer represents a large part of the CPI "basket," the methodology for collecting and adjusting data has remained consistent. We can all see the efficiencies and cost reductions that have been creeping into our lives due to technology; no longer paying for long distance phone calls, no longer having to get to the bank by 4:00 p.m. on a Friday to have cash for the weekend, cars that parallel park themselves, etc. So have data collection methods kept pace with the quality of life improvements we have experienced? This begs the question; are we basing our expectations about inflation on the right data?

Recent academic work by Martin Feldstein of Harvard University and Woody Brock, Ph.D. the president of Strategic Economic Decisions, have shed light on this issue of inflation measurement. Two clear problems exist, the incorporation of new goods and services into the consumption basket and the adjustments for qualitative enhancements. Cars are a good example of qualitative effects on prices. Not many people would argue that a car from 10 years ago is a higher quality car than one from the 2018 lineup. Besides parking on its own, there are a multitude of improvements that make today's cars' safety, reliability, fuel consumption, and connectivity outshine their older counterparts. Most of what is captured in the inflation data, however, is the *incremental* change of input costs from one year to the next (aluminum, steel, labor, electronics, rubber, plastics, etc.). So a positive conveyance of value has occurred over time due to quality enhancements and that value very likely exceeds the cumulative increase in costs to produce the car over those ten years. From the BLS's own CPI Handbook regarding automobiles: *"Also, new technology sometimes results in better quality at the same or reduced cost. Usually, no satisfactory value can be developed for such a change. In such cases, the quality change is ignored, and prices are compared directly."*

The broader implication is that the Digital Revolution may now be manifesting itself through a systemic increase in the supply of goods and services within our economy, though there has been no equivalent increase in aggregate demand. Demand has been constrained by demographic issues (e.g. the aging baby boom generation shifting their spending patterns) and the lingering effect of consumer debt accumulation from the 2000s, among other factors. If this is the case, as fundamental principles of economics suggest, an increase in Supply and no change in Demand will produce a decrease in Price. We are studying these forces to see if, in fact, the US is experiencing such a phenomenon and if that may be suppressing the widely reported and utilized inflation data.

It appears that our society has trained us to manage ourselves in a state of dualism and dualistic thinking; deliberating between yes and no, high and low, ones and zeros, inflationary or deflationary. In reality, there are often more than two states. Robert Pirsig in his 1974 classic *Zen and The Art of Motorcycle Maintenance,* refers to a third path by the Japanese word "*mu*." The financial markets constantly monitor economic data to either confirm or refute the existence of inflation. But the other way, the other path, is that toward higher quality.

Pirsig was an eminent thinker and writer about Quality and its role in the natural world; its interaction with the principles of physics, biology, and human evolution. We devote an important portion of our time as an Investment Committee considering quality at every level of the investment process, including security selection, portfolio management, and our business organization. From this thinking, we believe, like Pirsig, that quality is a natural state that all things move toward. It is an important part of the discussion of value and its persistence should not be overlooked.

> "The dualistic mind tends to think of *mu* occurrences in nature as a kind of contextual cheating, or irrelevance, but *mu* is found throughout all scientific investigation, and nature doesn't cheat, and nature's answers are never irrelevant." p.412
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> **Zen and the Art of Motorcycle Maintenance**

We may not see a sustained increase in bond yields for some time, perhaps due to a structural miscalculation of inflation. Unemployment levels are in the zone which makes the Federal Reserve feel compelled to raise the fed funds rate. But the evaluation of other assets will need revisiting. Some of the debate about "over priced" or "sky-high valuations" will simply need to be reconsidered.

The Digital Revolution has brought with it many conveniences and cost reductions in the way we live our lives. Our inclination is to believe that the network evolution (as an outgrowth of the Digital Revolution) may be taking hold and providing even more oomph - in the way that connected people all over the world are collectively able to provide buying power and scale advantages in the pursuit of goods and services at every turn, from shoes to financial services and hotel reservations. If so, this could partially explain the positive returns to stockholders over these past few years and also dilute the prevailing concerns over valuations. We continue to advocate an investment posture that is driven by each clients' goals and objectives, not market timing. We are primarily focusing on high quality investments within the stock and bond asset classes, with an emphasis on prudent diversification. Just because the market has advanced considerably from the 2009 lows does not mean a correction is imminent. However, we are students of the financial markets and readily acknowledge that there is a 100% probability that the stock market will correct by 10% *at some point*. Our view is that consistently predicting the timing of such moves is not possible. We remain vigilant in our search for the best possible combination of investments on your behalf and we are grateful for your support.

Best wishes for a wonderful rest of the summer.
