REAGAN'S REVIVAL

2016 Letter to Investors

The United States has evolved in countless ways over the past half-century. In the '60s, '70s, and '80s our society, sparked by an innovative spirit, spawned *Peace & Love; President John F. Kennedy; Rock & Roll; The Beatles; Martin Luther King Jr.; Neil Armstrong's small step; Star Wars; CNN; Pac-Man; Michael Jackson's moon walk; Warren Buffett; Bill Gates and Personal Computers.* From the '90s until now our way of life has been enriched by the *Internet; Steve Jobs; Apple; Starbucks; Google; GPS; Smart phones; Mobile devices; Amazon; Uber; Airbnb and Facebook.* We now live in a world that changes at the speed of light. It truly is a new dawn with limitless access and opportunities. America's exceptionalism has without question been alive and well. This brings up the question – will it continue? Before I attempt to answer this question, considering this is an election year, a historical lookback is in order.

2016 will stage the 45th running of the American Presidency. I sense that this election cycle is going to be one for the ages. The issues facing our nation are well known. The solutions to solving these problems are many. What is needed and missing at this point is cohesion and leadership. How does this year's election differ from those prior? Have we been down this road before? Let's have a look. On October 27th, 1964 just days before the running of the election in which Lyndon Johnson became President, Ronald Reagan broadcasted the epic speech, "A Time for Choosing." In an excerpt from Reagan's speech he stated the following:

> *I have an uncomfortable feeling that this prosperity isn't something on which we can base our hopes for the future. No nation in history has ever survived a tax burden that reached a third of its national income. Today, 37 cents out of every dollar earned in this country is the tax collector's share, and yet our government continues to spend $17 million a day more than the government takes in. We haven't balanced our budget 28 out of the last 34 years. We've raised our debt limit three times in the last twelve months, and now our national debt is one and a half times bigger than the combined debts of all the nations of the world. We have $15 billion in gold in our treasury; we don't own an ounce. Foreign dollar claims are $27.3 billion and we've just announced that the dollar of 1939 will now purchase 45 cents in its total value.*

It's as if this speech was written for today, with the only change being bigger numbers. In '64, the U.S. debt was $317 million, 51 years later in 2016 it stands near $19 trillion. Our national debt is now more than 100% of Gross Domestic Product; in the '60s debt-to-gdp was one-third that rate. The U.S. has consistently run a deficit since 2002. Total debt is close to topping $19 trillion, which equates to $58,327 in debt per person. The 2015 federal deficit was $439 billion. According to the Census Bureau, U.S. population is 322 million. In this past year indebtedness rose by $1,363 a person. If each of us manages our personal financial affairs in the same manner as our government, that is, perpetually loading up on more and more debt to spend on things we can't afford, what will be the outcome? This type of financial ineptitude will lead straight to the poor house. Our nation's finances are a bipartisan issue, Democrats and Republicans alike are well aware of the dilemma.

> Hillary Clinton, Democratic frontrunner said, *"I think that our rising debt level poses a national security threat."*
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> Donald Trump, Presidential hopeful said succinctly, *"I would be very strong on the debt limit."*
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> Admiral Mullen, former Chairman of the Joint Chiefs of Staff stated, *"The most significant threat to our national security is our debt."*

Reagan went on to express that Americans are increasingly being told they must choose between left or right. To this, he stated emphatically, *"I'd like to suggest there is no such thing as left or right. There's only up or down."* I strongly agree with this statement. America is nearing a crossroad pertaining to its finances. The question is apolitical; the question now is will the USA go up, or will it go down?

The United States is not the only leading country to be at this crossroad. Japan has become the prototype for countries using mounting debt to stave off assumed economic hardship. When the Japanese economy crashed during the late '80s, Japan aggressively employed deficit financing and quantitative easing to try to get the economy back on track. How has it worked out? For starters, the Japanese stock market, represented by the Nikkei Index, peaked at 38,915 on December 29, 1989; here we are 25 years later with the Nikkei trading in the 19,000 range and down over 50 percent from where it was a quarter century ago. Japan's GDP peaked in '97 and to this day remains beneath that level. During this period, Japan's debt-to-gdp rose to over 240%. The words, *lost decades*, serve well to reflect the past 20 years in Japan and it doesn't look likely to change anytime soon. Am I implying that the American economy is heading down the same path as Japan? How could I? It would not be patriotic. Empirically speaking, I do think that what happened in Japan over the past 20 years warrants contemplation. Burgeoning debt is no laughing matter. Uncomplimentary acronyms such as PIIGS are used to point out those countries whose indebtedness is called into question. PIIGS stands for Portugal, Italy, Ireland, Greece and Spain who collectively amass the highest debt-to-gdp ratios with the worst being Greece. How are all these countries including the USA navigating through these perilous waters? Their central banks create and circulate more cheap yen, euros and dollars. What is the collateral backing all this printed money? Ultimately, the answer is taxpayers. It is clear that our country's fiscal mismanagement must be addressed and can no longer be swept under the rug. We have to solve this problem. It is my hope that our government makes tackling its outstanding debt a top priority.

2015 had its share of ups and downs. The S&P 500 started the year at 2,058.90, and ended at 2,043.94, losing investors $14.96 for each share of the S&P Index owned for the year. In 2015, money was made by following the consumer. The Discretionary sector rose 8.43%, as consumer spending ramped up on strong employment and cheap gasoline. Health Care gained 5.21%, Technology 4.27% and Consumer Staples 3.77%. Losers were Telecom -1.73%, Financials -3.48%, Industrials -4.72%, Utilities -8.39% and Materials -10.36%. Energy by far was the biggest drag on market performance at -23.55%, well into bear market territory. Stocks on whole traded in a relatively narrow range with the S&P 500's high 2,130.82 and low 1,867.61. The spread differential between the high and low was 14%. This places 2015 high-low range in the bottom quintile of all years since 1945. According to Sam Stovall, S&P Chief Strategist, whenever the market's high-low range has been less than 15.5%, it posted an average 4.1% return the next year.

On December 17th, the Fed raised the Fed Funds rate for the first time in 10 years. The liftoff, as it has been aptly named, put a damper on year-end stock prices. During its FOMC meeting, Fed Chair Janet Yellen stated the Fed will remain accommodative. She pointed out areas of slack in the economy. Specifically, Yellen cited the depressed level of the labor force participation and the elevated amount of part-time employment. FOMC participants projected gradual fed funds rate increases from 0.25% presently to 1.5% late 2016, 2.5% late 2017 and 3.25% at 2018 year end. Higher rates are ultimately a good thing; they indicate the economic outlook is improving and that GDP growth appears sustainable. However, with rising rates comes increased volatility. Again referencing Sam Stovall – historically, the days of 1% or more volatility during the quarter following the initial rate hike has increased by 77%. Lower P/E multiples are likely if the Fed remains on course with a series of rate increases.

In my opinion, stock market performance is likely to be driven more on financial results and less on investor sentiment. Consensus earnings estimates for 2016 are $127.02 for the S&P 500. If the P/E multiple retreats modestly due to rising rates and the economy remains on track, considering the Fed's accommodative stance, a 16.5 multiple is not unreasonable. Multiplying a $127.02 street estimate by 16.5 P/E equals a 2,095 price target or a 2.5% gain for the S&P 500 in 2016; adding in dividends this equates to a total return of 4.7%.

Respectfully,

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