July 25, 2017

Dear Client:

The last eighteen months have been a humbling time for investors who have failed to keep in mind that equity prices are driven, above all, by two fundamental factors: earnings and interest rates. Extrinsic forces, such as political phenomena, rarely have a meaningful impact on the stock market except through those two basic variables. Thus, while recent global and domestic political events have generated a great deal of noise in the financial realm, they have done little to change what has been a very positive earnings and interest rate environment, and so the bull market in equities has continued more or less unabated.

We have discussed at length in prior letters the nature of this underlying economic environment, but given that prices have risen meaningfully over the last few quarters, it seems worth our reiterating the basic story that has continued to push the market higher. First of all, after a five-quarter "earnings recession," corporate profits have rebounded nicely since Q4 2016. In fact, earnings have been growing much faster than the overall economy, which continues to plod along at roughly 2% growth. Such a disparity between earnings and general economic performance is possible, among other reasons, because a greater share of growth has accrued to capital – i.e., corporations and their shareholders – versus labor. And since it is corporate profits rather than overall economic growth that drives stock prices, the market has performed well this year despite a still-lackluster economy. (We are, of course, leaving aside the long-term social and political consequences of what many describe as this ongoing triumph of capital at the expense of labor, including its implications for the future of the American middle class – a phenomenon that could have an enormous impact on the economy and the stock market over the very long run, but which is for the time being beyond the scope of our letters.)

Interestingly, this imbalance in the distribution of the fruits of growth between capital and labor has, in the form of a lack of meaningful wage growth, also been at the root of the interest rate half of the picture. Almost no matter how low the labor force participation rate – and it remains historically depressed in the aftermath of the Great Recession – a headline unemployment rate of 4.3% would seemingly be low enough to create some upward pressure on wages, which should in turn spur inflation. Yet wage pressure has yet to appear in earnest, and even such minimal wage growth as has occurred has not given rise to inflation. In fact, inflation declined over the last several months. We can speculate as to why this causal chain between lower unemployment and higher inflation, known technically as the Phillips Curve, has broken down in recent years – the deflationary influence of technology, international labor competition, and lingering trauma from the Great Recession have likely all played a role – but the bottom line is that inflation remains essentially dormant. And without a real uptick in inflation, the Federal Reserve will be compelled to keep short-term interest rates at their current, historically low levels. So unless and until we see inflation start to pick up meaningfully, we will remain in the same low-interest-rate regime that has prevailed since the Financial Crisis and that has been so favorable for equities over the past eight years.

Notwithstanding our admonition at the beginning of this letter that the economic fundamentals are paramount, we clearly cannot dismiss the political realm entirely. One thing we are not particularly concerned about from the standpoint of the stock market, however, is the Russia scandal in which the Trump Administration remains embroiled. In other circumstances, one might reasonably fear that such a distraction, which promises to drag on for many more months if not years, might lead to gridlock in Washington and cause progress on market-friendly legislative activities to grind to a halt. But how would such a situation be any different from the current state of affairs? Precious little, for better or worse depending on your perspective, has been accomplished in Washington in many years, and yet during that period we have enjoyed one of the longest and smoothest bull runs in history. True, the market would welcome tax cuts and tax reform, but we find it hard to believe that investors would be foolish enough, in the current political environment, to be truly counting on – and therefore already fully pricing in – sweeping tax legislation. What will determine where the market goes from here are the same basic forces that have pushed equity prices higher since 2009: earnings and interest rates.

As for the possibility, which appears increasingly plausible, that Russia-related revelations will emerge that would compel reluctant Congressional Republicans to move against President Trump in earnest, we are paying close attention but are not as worried, with respect to the market, as the news coverage might suggest we ought to be. In each of the three historical cases involving impeachment or the threat thereof, Congress was controlled by the de facto opposition (we say "de facto" because Andrew Johnson, while technically a Republican as Lincoln's second running mate, was in substance a Democrat opposed by his nominal party). Therefore, in each of those cases the President could be *impeached* in the House by the majority vote of the opposition but not necessarily *convicted* in the Senate, and hence removed from office, due to the need for a two-thirds vote, which would have required significant elements of the President's own party to turn on him. The consequence, in the instances of Johnson and Clinton, was lengthy impeachment proceedings that did not result in removal from office. In our case, however, there will be no impeachment in the first place without substantial Republican support for it. But if the Republicans at some point feel forced to impeach Trump, conviction and removal would almost certainly follow, since the Republicans will have already broken with him and every single Senate Democrat could be counted on to vote for conviction. And the Republicans' incentive in such a scenario would be to proceed as quickly as they could both to give Vice President Pence as close to a full term as possible and to salvage what they could from the following election cycle. We imagine the market would experience a hiccup in such circumstances, but we believe investors would welcome a Pence presidency.

Some caveats, of course, are in order here. Should impeachment become likely, we suspect events might unfold in a rather non-linear fashion, and we are not eager to see what Trump might do if truly cornered. At the very least, his behavior in such a scenario would be difficult to predict. He might discover unforeseen ways to draw out or stall the impeachment process, with consequences for the economy that would be impossible to forecast. He might pursue a scorched-earth strategy that would damage consumer and business confidence and lead to recession. He might attack North Korea. (Even without the impetus of domestic political circumstances, tensions with the latter have increased in recent months and bear close watching. North Korea's apparently successful test launch of an intermediate-range ballistic missile on July 4 represents a dangerous escalation that shrinks the window for dealing with the North Korean nuclear threat before the "Hermit Kingdom" possesses ICBM's capable of reaching the U.S. mainland.) One way or another, Trump would almost certainly not go quietly. And even if events proceeded comparatively smoothly, investors might fear a left-wing Democratic takeover of Congress in 2018 and the White House in 2020 that could lead to the implementation of market-unfriendly legislation and regulation. Finally, while the expansion still looks to be on fairly solid footing, we will inevitably have another recession at some point. And while our increasingly toxic politics has yet to have a tangible impact on the economy, perhaps the ongoing circus in Washington will only truly make itself felt in an economic environment that has already turned negative due to more ordinary, cyclical factors. In this way, even a garden-variety downturn would have the potential to turn into something more damaging.

Still, one would have to be a true perma-bear not to appreciate the remarkable durability that the prevailing economic regime – slow to moderate growth with historically low inflation and interest rates – has demonstrated even in the face of the rather wild political events of the last year plus. If the economy and stock market have more than weathered the storm thus far, it is difficult to see how more of the same, even the above-discussed case of impeachment, would capsize them. In our view, the end of the current economic recovery and bull market is much more likely to arise from intrinsic economic forces that have a direct impact on the fundamentals. After eight years of growth, it is certainly reasonable to be on the lookout for signs of the end. But duration is not the only, or even the most important, indication of when an economic expansion is due to expire. The most salient aspect of the current recovery is not its length but rather its gradualness. This same gradualness that has frustrated economists and politicians has also helped to curb the sorts of distortions, excesses, and exuberance that often infect expansions and bull markets in their later stages and cause their collapse. In fact, were the pace of the recovery to pick up substantially, that is precisely how we could get the sort of overheating and inflation that would impel the Fed to raise rates quickly and sharply, thereby likely choking off the expansion. But just as there are no signs that growth is collapsing, there are also no signs that it is meaningfully accelerating. We remain on the "goldilocks" path of growth that is neither too cold nor too hot.

Thus, although the still-ongoing recovery has already lasted longer than most, we do not assume that we are necessarily in its very late innings. As for the stock market, while valuations are certainly no longer cheap like in 2009 or 2012, neither

do we believe that they are expensive in light of the prevailing regime of healthy corporate profits and rock-bottom inflation and interest rates. We see no signs of this regime collapsing over the short to intermediate term, and therefore we remain bullish on U.S. equities.

If there have been any changes in your investment objectives or in your personal or financial circumstances, or if you have any questions or comments, please give us a call.

Sincerely,

Michael G. Hofkin

Benjamin J. Hofkin

(A copy of our disclosure brochure is available upon request.)