# ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
October 6, 2016

**Dear Clients:**

The father of Keynesian Economic Theory once remarked "The difficulty lies not so much in developing new ideas as in escaping from old ones". Of course, new ideas are not necessarily better than old ones, but applying those that are effective is a necessity.

John Maynard Keynes developed his theory of macro-economics during the 1930's in an effort to understand the causes of the Great Depression and to develop societal policies that would help avoid or substantially lessen the adverse effects of a recurrence. From this landmark economic work, a deeply-imbedded faith in the effectiveness of government spending and easy money policies as fuel for resuscitating a lethargic economy has influenced the economic activities of western societies ever since. As evidence, one need only look at the actions of the US federal government and the US Federal Reserve Bank (FRB) since the Great Recession of 2008 where the federal budget deficit has risen dramatically and interest rates have been held at historically low levels for the entire eight year period. Yet, post-recession economic growth remains well below historical norms and large swaths of the American workforce remain either unemployed or under-employed. We can only guess at what Keynes, who died in 1946, would say about the effectiveness of the application of his theories since the 1930s; but we doubt he envisioned a "permanent" state of annual budget deficits and high debt to GDP levels as effective policy tools. To the extent governmental budget surpluses are even possible today, perhaps pursuit of such a novel occurrence would represent a "new" idea worth considering.

A profoundly "new" economic policy tool is the zero interest rate policy (aka zirp). Ever since Congress in 1978 legislated the dual mandate of full employment and stable prices, the US Federal Reserve Bank has been forced to make policy tradeoffs in pursuit of these contradictory objectives. Most seasoned investors today remember the high inflation rates of the late 1970s and early 1980s and the extraordinarily high interest rates supported by the FRB to bring down inflation to more sustainable levels. This action combined with the beginning of the decades long development of modern technology led to sustained economic growth throughout the twenty years 1980-1999. After 1999, the economy has had to absorb the headwinds of a long term "war on terrorism" and the dampening pressure on wages from globalization. The FRB chose to offset these pressures with easy money policies, including zirp, that subsidized the price bubbles in residential housing between 2000 and 2007 and what many consider the asset price bubble for stocks, bonds, and commercial real estate that continues to this day. In this circumstance, we suspect the "old" idea of strong money and real interest returns is preferred. If only Milton Friedman was still around to help us expose the mischief in the current monetary policy approach.

This brings us to another "old" idea being challenged this year – the notion that our two-party political system for vetting the most qualified candidates to hold the highest offices in federal, state, and local governments actually works. News pundits tell us every day that the two presidential candidates of the major political parties each has the highest negative ratings by voters recorded in modern times. Both candidates offer the prescription of aggressive governmental action to improve the lives of ordinary American citizens. Although the policy prescriptions between the two candidates may differ, until one is elected and makes actionable proposals, it is hard to predict what impact such actions will have on economic activity and asset prices for stocks, bonds, and real estate. On balance, we would vote for something "new" on this front given our current choices, but that change is at least another election cycle away from implementation.

## Investment Market Returns as of September 30, 2016

Investment returns during the third quarter showed remarkable strength across most asset classes with a couple of notable exceptions. US stock prices continued the upward movement this year with a 3.9% total return from the S&P 500 Index; the resultant year to date total return was 7.8%, with only about 1.5% coming from dividends. US small company returns were even stronger as the Russell 2000 Index returned 9.0% and 11.5%, respectively, for the quarter and year to date. Not be out done, returns on international stocks were also strong as the evidenced by three month returns of 6.4% and 9.0%, respectively in USD, from the developed foreign markets and the emerging markets. Strong equity returns were achieved despite continued softness in revenues and earnings worldwide, stresses in the European banking sector, and geo-political tensions in the Middle East and Far East. Perhaps, the forward looking nature of equity price movements suggests better times ahead; we certainly hope so.

Returns on fixed income assets were a mixed bag for the quarter. US taxable investment grade bonds returned about 0.50% or roughly the interest coupon for the quarter, while US tax exempt bonds posted a negative -0.3% return as price declines more than offset the 0.45% coupon return. Time will tell whether these signals harmonize in the future, but our guess is that the future inflation trends may be showing up in bond prices. Further evidence of this trend is supported by the return on US TIPS bonds which was 1% for the quarter and 7.3% year to date.
Foreign bond returns were an almost pedestrian 0.4% for the quarter as the trend away from negative yields on major sovereign bonds began. Year to date US bond returns ranged between 4.0% and 5.8%, while the foreign bond index of major sovereign issuers reflected a return of 15.5%. Investors should take notice that price changes go both ways and future yields are more likely to go up rather than down from here.

The Alternatives asset returns demonstrated some of the notable disconnections in the markets. The US REIT index declined -1.2% for the quarter; we generally associate such movements with rising interest yields and/or declining demand for commercial real estate. Again, this action may be an early signal of future conditions. On the other hand, commodity prices declined -3.9% during the same period, which suggests lessened inflation pressures.

## Our Look Forward

Our crystal ball for future investment returns is calibrated on our belief that stock and bond returns result from rational components beginning with the annual inflation rate. History (aka "old") says the annual inflation rate has average around 3% as has the daily funds or savings rate. Bond yields have averaged about 2.5% above the inflation rate and equity returns (price growth plus dividends) have added another 4.5% or more on top. Of course, such returns are averages achieved over many years of ups and downs, but we find them to be a rational foundation. By comparison, we see current (dare we say "new") component returns of 1.8% for expected inflation, 0.4% daily funds or savings rate (a negative real money rate of -1.4%), 1.8% 10yr UST yield (zero real return for a ten year period), and a 2.2% total return premium for stocks over inflation. Robust economic growth in the US and abroad will eventually provide the foundation for higher earnings and higher interest rates. However, we do not yet see the policy prescriptions in place or being proposed to facilitate the desired economic vitality near term. We do not think the "new" investment return expectations described above are sustainable simply because the risk premiums are too low to provide adequate compensation for the variability of future events and conditions. With such low expected return factors, seemingly minor changes in future expectations can have a dramatic impact on asset prices, particularly those with extended durations. We think this risk is best managed with below normal equity exposures and bond durations, a focus on quality, and a reasonable level of dry powder. Keynes once said "Markets can remain irrational longer than you can remain solvent". He was speaking of the dangers of margin debt and short selling of which we do neither. We do think today's "new" return factors a bit irrational and feel capital preservation deserves equal consideration with return objectives.

**In Closing**

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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