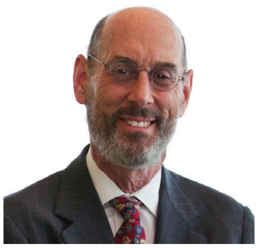
SBH NEWSLETTER

Thoughts on the Current Environment



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The day after the election this past November, we received a number of calls from clients asking how our view of the economy and the markets had changed, given an outcome that was a surprise to almost everyone. (Well, that's not all they asked or said, but we do have some editorial standards to which we try to adhere.) We responded with a note we sent to all clients. In part, it read:

> *For most of our clients, investing is a long-term proposition, not a series of trades on short-term developments. Our investment approach has never been to weight short-term volatility too heavily, and there is no reason to begin doing so now. We believe, with some concerns that we have expressed previously, that the long-term opportunities in the markets remain good and that we should be constantly on the lookout for opportunities to introduce new or add to existing investment ideas that meet our criteria.*
>
> *The focus when we make investment decisions keeps that point in mind. In that respect, nothing has changed from yesterday, before the election, to today, after it.*

Immediately following the distribution of that note, the stock market went on a tear as "animal spirits" ran high in the post-election period. The Dow Jones Industrial Average, not an index very representative of the economy but still probably the most recognized of market indicators, flirted with surpassing the 20,000 level in late December, but did not quite manage to break that barrier. Smaller stocks, as measured by the Russell 2000 Index, performed extremely well, rising nearly 9% in the fourth quarter alone. The possibilities afforded by tax cuts and reduced regulation have caused a meaningful increase in the market's expectation of how fast the economy and corporate profits can grow.

And yet some of the underlying problems remain. Will this be a case of "Buy the Election, Sell the Inauguration"? No spoiler alert need be provided; we can readily say, "We don't know." What we do know is this. A year ago, the U.S. Federal Reserve (Fed) raised the benchmark rate (which it can control) by a quarter of a percentage point.

Although this move was well anticipated by the markets, it is worth recalling that by mid-February, the stock market (depending on the benchmark) was down roughly 11%, yields on low-rated junk bonds were rising because of concerns over higher default rates and the Chinese economy—the source of incremental global growth in the last two decades—was also seen to be at risk. This year, the Fed raised the same rate, again in December, and again with almost no surprise factor to the announcement. This time, the markets appear to have absorbed the news in stride.

What's different? Clearly, the change in leadership in Washington has altered the general mindset about the capability of the economy to grow. What hasn't changed? The issues that gave risk to those concerns over the ability of the economy to sustain growth; concerns over what the level of that sustainable growth truly is; concerns about the political stability of Europe in light of the Brexit vote, the Italian constitutional referendum and the pending elections in France; concerns about the condition of China, which has seen governmental crackdowns both on political dissidents and on people trying to move capital out of the country (never a good sign); concerns about relations with Russia; and, last but surely not least, the relatively limited government experience of the new administration are just a few of the concerns. Right now, the real question, which is another way of phrasing the question of whether to "Buy the Election, Sell the Inauguration," is this: does the risk premium that investors should be looking for go up in the face of all of these uncertainties, or does it go down in the hopes that a new perspective will unshackle growth. Along with the rest of the country (and the world), we will be carefully watching.

In the early Fall, I had the opportunity to hear Professor Robert Gordon of Northwestern University (and a member of the Business Cycle Dating Committee of the National Bureau of Economic Research, which is responsible for determining when recessions start and end) speak to a small group about his recent book, *The Rise and Fall of American Growth: The U.S. Standard of Living Since the Civil War.*[1] This is a massive work drawn on a vast amount of scholarly research. Gordon's work provides the basis for suggesting that the current secular stagnation of many global economies may be longer lasting in nature than many imagine. The risk is due to a slowdown in productivity growth, which Gordon believes will be long lasting.

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It is impossible to summarize Gordon's work in an essay of this size. In brief, he proposes that we should think about innovation in the following context. There have been three distinct Industrial Revolutions since 1770. The first ran from 1770 to 1840, led by the harnessing of steam to provide energy either in transportation (steamships and railroads) or in manufacturing (clothing mills, steel mills). The second ran from 1870 to 1920, which saw the widespread implementation of electricity (lighting, air conditioning, elevators, radio/TV) and chemical innovations (plastics and medicines) that boosted standards of living widely. The third revolution, in which we currently remain, is what Gordon calls the "EICT" Revolution, encompassing Entertainment, Information Technology, Communications and Productivity Enhancers (think: ATMs). In a nutshell, his thesis can be summarized by observing that the invention of the steam engine had a more profound effect on peoples' lives than the invention of the iPhone. He notes that productivity gains in this third era have stagnated for the last 30 years, with only a blip in the period 1996–2004, corresponding to the evolution of

[1] Princeton University Press, 2016

the World Wide Web. Since 2004, broad economic gains driven by the Web have disappeared. His conclusions are that innovation will continue, but to a lesser degree; that growth in the future will be much slower than in the past because of demographic headwinds (slowing population growth, growth in single-parent households, growing significance of educational gaps) and (but?) that the moderate pace of innovation will mean that jobs will not disappear en masse.

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While it's a sobering book, I think it should be read more as a cautionary tale rather than a bleak forecast of what's to come. As it happens, I also recently finished a book entitled *Paper* by Mark Kurlansky.[2] Kurlansky's previous books include *Salt* and *Cod*. (Catchy titles, huh?) His skill as a historian lies in his ability to take common, mundane products and in the process of explaining their history, explain aspects of human development. In *Paper*, Kurlansky argues that the crucial ingredient to human development from the invention of paper lay in paper's ability to help broadly disseminate human knowledge and to preserve knowledge beyond the lifespan of its creator. Creating surfaces on which to inscribe information goes back, of course, to pre-historic times with paintings on cave walls. When the process for making paper was finally worked through (in China, prior to 1000), the means to readily produce and distribute information and knowledge were significantly enhanced.

Widespread production and use of paper, however, never took hold in Asia (for reasons beyond this essay). It made its way to Europe through the trade routes. First it reached Spain, which attempted to control production and restrict distribution of paper. That was unsuccessful, and paper production made its way further West into Europe. One can link Gordon's First Industrial Revolution with the idea that the accretion of human knowledge had finally hit a "lift-off" point around 1770, which resulted in an explosion of innovation. Kurlansky's book ends on the observation that the role of paper in facilitating the growth of human knowledge is over. The internet has replaced paper in cost, speed and accessibility to produce exponential growth in discovery and distribution of knowledge.

Kurlanksy's ideas dovetail with those of one of my favorite books, *The Rational Optimist: How Prosperity Evolves,* by Matt Ridley.[3] Ridley's whole delightful book can best be summed up by the title of his prologue: "….when ideas have sex." Mental wealth and material wealth go hand in hand over time, and the supply of raw material needed to achieve this outcome, human mental capacity, is inexhaustible. Together, these two books make a strong case that the critical resource needed to improve life for all on Earth, the ability of the human mind to create and innovate, is not one in short supply. Warren Buffett famously asked in his 2014 Shareholder Letter, "Who has ever benefited over the last 238 years from betting against America?"[4] I would ask the same question in regard to the "investment merits" of the human mind to solve problems.

We wish you a happy and healthy 2017……And your portfolio as well.

[2] W.W. Norton & Co., 2016
[3] Harper Collins, 2010
[4] Annual Report, Berkshire Hathaway, 2014

MARKET BAROMETERS
AS OF DECEMBER 31, 2016

	Dec 31, 2015	1Q16 2Q16 3Q16 4Q16	Dec 31, 2016	Low	High
Dow Jones Industrial Index	17,425.03		19,762.60	15,660.18	19,974.62
S&P 500 Index	2,017.10		2,236.20	1,800.40	2,267.80
Russell 3000 Stock Index	1,206.10		1,331.72	1,067.34	1,351.50
Russell 2000 Stock Index	1,135.89		1,357.13	953.72	1,388.07
Russell Midcap Growth Index	738.40		782.97	636.09	798.75
Barclays Cap Aggregate Index	1,916.49		1,967.23	1,916.49	2,034.61
Barclays Cap Muni Bond Index	1,136.69		1,139.51	1,121.83	1,189.82
Gold (Price/Oz) London AM Fix	1,062.25		1,159.10	1,062.25	1,370.00
Goldman Commodity Index	2,170.61		2,417.31	1,860.66	2,497.27

Source: Bloomberg

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