April 6, 2016

Turbulent Quarter

Dear Investor:

The first quarter of 2016 has been a very rough ride for investors. The stock market basically went down for the first six weeks of the year to end up over 10% below where it finished in 2015. The volatility was high with many big selloffs and down days. From there, it has worked its way back up and is slightly in the black for the year to date. That's a huge amount of action in just thirteen weeks. One article I read stated that we haven't had a quarter like that since 1933. So, what's going on?

Initial estimates of fourth quarter 2015 GDP growth were very low, around 0.7%. This naturally led to fears that the recovery was fading, and we might be heading for a recession. Since we know growth is slow everywhere else, the idea of the US slowing down carried a lot of weight. The bottom was still falling out of oil earlier in the quarter, and the situation in China was not improved. There was bad news everywhere and that was all people could see, or so it seemed. The fear began to feed on itself and picked up a head of steam, as it usually does. Many were questioning why the Fed had raised rates and thought they made a mistake that would have to be rescinded. We also remember that the US market was essentially flat in 2015. Putting all these things together made for a very negative outlook.

After the usual two revisions, the fourth quarter GDP was raised to 1.4%. While not great, it clearly showed we were not in recession. Most of the upward revision came from higher consumer spending, which is very good news. Consumer spending is over two thirds of the economy. This is not a complete surprise when you realize that we are still creating new jobs every single month. The performance of the labor market is tremendously important. Some economists believe it is the most important measure of what's happening in the economy. As people go back to work, they have more money to spend and this helps us all. Looking back, it seems like another soft spot in an economy that is still moving forward at a slow and somewhat steady pace.

As I mentioned, many people were coming to the conclusion that the Fed had made a mistake in raising rates. I am not in that camp. I'm relieved that they held firm during the turmoil and did not back down. Pulling back on rates so soon would have led to an enormous loss of confidence and even greater turbulence. We need to press forward to more normal levels of interest rates. The trick is to do it in a gradual way that will not snuff out the recovery. One of our biggest problems right now is that we are the only one. The other major economies are still easing, and China is continuing to decelerate. This keeps upward pressure on the dollar which is a headwind for us in many ways.

Another big problem is China. Their situation is creating a significant degree of uncertainty for us, as it's very difficult to gauge how the slowdown there will affect our recovery. We really don't know and we have little to no control over the situation. The issue is with their currency, the yuan. Their

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slowing economy puts downward pressure on the yuan, lowering its value against the dollar. This makes it harder for us to move forward with normalizing our interest rates. It's like we are importing deflation while we are trying to reflate our own economy. You may remember what happened last August. The Fed was poised to raise rates for the first time when we were shocked by a currency devaluation from China. The Fed held off, and the market tumbled for six weeks. The PBOC (People's Bank of China), their central bank, has been trying to slow devaluation down by using their currency reserves to support the yuan. They have burnt through a lot of reserves, and many economists don't think they can keep it up much longer. That remains to be seen. An updated report on their reserve levels is coming out later this week.

Another problem they have is with their banks. They have made trillions worth of loans in the last ten years. You have probably seen the stories on TV of the empty office buildings, apartments, and even cities. China has overbuilt, at least in the short run, and it's likely that a lot of these loans will go bad. Many already have. This may force the Chinese government to enter into bailouts or loans that will affect their economy and reserves even further. That would also play into forcing the yuan down on world currency markets. These issues are why recent commentary and minutes from the Fed meetings have talked about global risks to the downside. They would like to see clearer signs that China has things under control and that growth in the US will not be hindered.

We live in very challenging times. There's no way to get around that fact. Governments and central banks around the world are going to unprecedented lengths to try and support the global economy. There's no way to know how long this can go on, or if things will ever get back to "normal". The US is clearly in a modest recovery. All the facts support that, so we have been investing accordingly. Naturally, we have no guarantee that it will continue. We have seen a much better picture in the housing market, and there are some signs that the decline in manufacturing may have bottomed with indicators turning up. Oil has firmed up and is doing a little better. Early estimates of first quarter growth are low, but they are still positive. While there have always been problems in the world, it does seem true that risk levels are elevated due to the fragile global economy. This may well lead to increased volatility, and may be one reason that the first quarter of the year was so extreme in both directions. I appreciate your patience as I realize these large moves can be scary. There are many well managed and profitable companies in the US and around the world. Our hope as investors is that we will be rewarded for owning shares in them. We need to remain calm and stay the course. Please contact me anytime to discuss your portfolio.

Best Regards,

David E. Keim

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Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict.

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