RBC Wealth Management

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July 8, 2016

"There must be some kind of way out of here,
said the joker to the thief,
there's too much confusion, I can't get no relief."

-Jimi Hendrix: *All Along the Watchtower*, 1968

Dear Friends,

We watched last week as Fed Chair Yellen testified before Congress about the conundrum facing the grand Pooh-Bahs at the Fed. To raise or not to raise? But is that the question? Maybe not. Is it possible what is *really* puzzling the dedicated public servants at the Fed is that central banks around the world have actually lost their effectiveness? If interest rates below zero in Europe and Japan can't do the trick, can the trick be done? All good questions. Wouldn't you love to get your hands on Ms. Yellen's playlist and see if Jimi's recording of *All Along the Watchtower* is among her most frequently played?

**"Sometimes I Even Scare Myself"**

Of late as we sit down to share our thoughts with you, we find ourselves behaving like the Cowardly Lion of Oz who had a unique ability to simply scare himself. But the fact is, there are plenty of things out there to be concerned about. It will not surprise you to learn that we have a careworn list.

- *Jobs and the Fed:* With wages picking up, some employers are pulling back. Why? Our guesses… employees are getting more expensive at a rate well above inflation. Things like health insurance, a shortage of qualified people (driving up what you have to pay to hire one) and the sky rocketing dollar making our goods less competitive in world markets are all factors. Clearly the Fed was spooked by this data when it came to boosting the Fed Funds rate by even a quarter point at the June meeting. As in, they didn't. And who knows when they will or can? The very concept of countries borrowing money at rates beginning with a decimal point simply boggles the mind. There *must* be some way out of here!
- *Stalled profits*: Profit growth has been deaccelerating for a number of quarters. At the start of the year the consensus for growth in earnings for the companies making up the Standard and Poors 500 was in the range of 6%. Most commentators of late have reduced their estimates materially. RBC's own numbers have dropped from 6 ½ to 7% to 4.9% presently.
- *Microscopic interest rates* are widely perceived as a sign of economic weakness. Correctly so. Following the vote in Great Britain to withdraw from the EU, the ten year US Treasury note is now yielding its lowest return on record. *Literally* all time to include the service of Alexander Hamilton, star of the US Treasury, stage and duels-of-honor.
- *Earnings:* Not nearly enough to go around. We wrote to you in January and pointed out that the year ended with stocks selling at an average of 23.5x trailing twelve months earnings, a level exceeded on only three occasions in the prior 45 years. What has happened since? Based upon Dow Jones News Wire data, stocks entered the third quarter changing hands at nearly 24.5x, over 4% higher than the start of the year. In itself that would not be a source of great concern except for the fact that earnings expectations are trending lower, not growing. Paying more for less?
- Finally, it's just plain weird out there. The world seems upside down. The Brits voted in favor of collapsing their currency, achieved chaos, a new round of bank fright and a drop of 10% in their stock market. Across the Atlantic, Brazil's government collapsed under graft, impeachments, a

mid-teens inflation rate, the Zika virus and a declared national crisis around the Olympics… yet, according to Barrons, their stock market went up 46%. Closer to home, stocks which are supposed to produce capital gains, returned 2.7% before dividends while the ten year Treasury bond returned nearly 8% while paying interest at a microscopic rate. (Over 7/8ths of this return came from capital appreciation.) If you wanted yield, you had to buy better dividend paying stocks. China, which was the market's boogie-man in January, went radio silent. Then there is oil. Seen as a sure-fire bet to trade lower, oil managed to nearly *double* in price to over $50 before the end of June. (Please see our timely contrary opinion piece "Burning Fires" in our Letter of January 25, 2016.) Oil stocks were among the quarter's best performers. As we say… weird.

**Dwindling Potential…**

was the term Wall Street Journal writer Greg Ip recently used to describe the underlying growth prospects for the US economy. In part because the economy and stocks are highly correlated, it is fair to ask, *What sort of risk-reward proposition do stocks here in the US present today?* Our thoughts:

- Fortunately, prospects are better here than in most of the world.
- Not so good on a scale measuring historic returns when the stock market is priced as expensively as it is in the US today. For the most part, this game has ended badly.
- Especially expensive today are the very largest, stable demand household name companies such as Pepsi, P&G, J&J, Verizon, AT&T, electric utilities and the like. The dividends are nice but the price in relation to nearly all measures, not so much.
- The environment is unusually challenging in the sense that the Fed has gamed the system with their low interest rate policies resulting in investors onboarding risks they may not fully understand in prioritizing stocks over bonds simply because they must. The acronym used to describe this phenomena is TINA…There Is No Alternative. Really?
- One risk we do understand is that low interest rates which stimulate consumption have the effect of importing the future into the present. All those cars being purchased today at low rates will depress demand two or three years down the road. (Bad pun.) We saw an ad this week offering both a car and $6,000 in *cash* all financed at low rates if you will drive one off today.
- Corporations are borrowing vast amounts of money, much of which is being used to buy back stock. As this trend will eventually slow, an important prop for the stock market will evaporate.

**Higher Hanging Fruit**

As most of us have at some point in our lives stood nervously near the top of a ladder in an effort to get at some of the best remaining fruit, herewith follows our suggestions as to how to deal with Dwindling Potential.

- There are times when it is best to invert the old adage and simply… don't do something, just stand there. While settling for low returns for a protracted period is annoying, disciplined investing may require we do just that. Our version of *don't do something* is very short term, investment grade bonds and CDs. Yields today for these instruments average about 1%. We tend to own this paper on a serial basis so that we have bonds maturing with great frequency. We have no way of knowing when a buying opportunity such as we briefly had in mid-January will come along and therefore want to have dry powder at hand. (More to follow on this topic.) Let us be clear; this is not an attempt to call a market top, truly a fool's errand, but rather gracefully accepting limitations when they are imposed upon us.
- Warren Buffet advises investors to be fearful when others are greedy and greedy when others are fearful: the quintessential definition of contrary investing. While this philosophy has served him and investors in Berkshire Hathaway well over the decades, the reality is that he practices this

approach on a micro basis, not a macro one. He puts his energies into identifying individual companies which present an attractive value proposition, not an exchange traded fund which mirrors the S&P 500. Instructively, Buffett's sales year-to-date have included current trendy stocks P&G, AT&T and MasterCard (all seen as stable demand safe-harbors) while purchases have included Apple, energy producer Phillips 66 and long suffering IBM. Buffett managed to find these value driven investments in a market which was otherwise absent widespread opportunity.

- In our case, late last year we re-visited a situation within a sector of the market to which we have historically been underexposed, and until 2014 avoided entirely…real estate investment trusts. Late in the fourth quarter and into the new year we materially increased our investment in New Senior Investment Group (NYSE: SNR), a stock which had lost roughly half its value in the preceding nine months. Collectively, on behalf of our clients, we now own nearly 2% of the company. A vendor primarily of independent living services to seniors, SNR was trading so cheaply that the company acquired over $40 million of its own stock (approximately 5% of total shares outstanding) through open market purchases and a self-tender for its shares. We viewed the dividend as safe despite providing what could be considered a suspect return that exceeded 13% before the recovery in price. Year-to-date, between dividends and $1.04 in appreciation per share, SNR has returned over 15% to its holders, about a four-fold increase over the 3.6% return of the broad market: truly a market of stocks as opposed to a stock market.
- Another standout for the first half was the oils which rebounded mightily on the heels of both crude and natural gas. Examples include British Petroleum +17%, Royal Dutch +25%, and the smaller companies such as Devon Energy +14%. Other significant dividend payers such as GlaxoSmithKline, Pfizer, and Verizon (which became a source of cash late in the quarter) also provided returns above that of the broad market averages. While each of our accounts are managed individually, as a general statement it was a good quarter and first half. Asset allocation is conservative, portfolio yield is up and the storm windows are in place.

What about our annual recommendations for summer vacation this year? At least from a pocket book standpoint, prior to the Brexit vote and the collapse in both pound sterling and the Euro, we would have advised renting a very nice mountain cabin or chartering a well maintained 38-footer for a week up in the San Juan Islands. Given the fact that those currencies have folded up like a cheap tent in a high wind and airline tickets are said to be selling very cheaply, maybe a week in the British Isles or Spain is in the cards while remaining fiscally responsible. Break out the passports!

As always, our thanks go out to all of you for your friendship and patronage. Please do not hesitate to give us a call in the event you have any questions. We are often wrong but never in doubt!

Best regards,


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| Steve Spence | Marcia Hull | Kip Acheson | Chris Klavins |
| Senior Vice President | First Vice President | First Vice President | First Vice President |
| Sr. Portfolio Manager | Financial Advisor | Financial Advisor | Financial Advisor |
| Financial Advisor | | | |

**The Klavins Report – Thoughts From Outside the Corner Office**

Since my partner Steve did an admirable job of describing economic conditions and implications for the market (…I'm beginning to think he might have a future in this business), I'm going to keep my comments brief. In fact, I'm going to skip prognostications altogether and simply share a bit of news about our team.

***Onward and upward…***

One of the dangers associated with hiring *truly talented* people is that they are often asked to take on new challenges. While a known risk, we have always chosen to aim high with our hires and risk a bit of turnover.

Along those lines, our friend and colleague Susan Haas, with whom we've had the pleasure to work for the last two years, has decided to enter a management track with RBC. While we are admittedly a bit sad at this development, we are thrilled for Susan and glad to know that we and our parent organization will continue to benefit from her talents. Susan will be with our team through August 12th, at which point she'll transition to her new role in the branch. We wish Susan well in her future endeavors, and thank her for her service.

***Next steps…***

Rest assured that we are beating the brush in our search for a qualified person to fill Susan's outsized Jimmy Choos and Manolo Blahniks.

In the meantime, as we look for a replacement who is the right fit for our team and for you, our valued clients, know that the immensely talented Kathy Crocker is still here and leading our client service efforts. Kathy delights in taking care of you and your needs, and is up to the task of seeing us through while we find and train a new person. She can be reached at (503) 833-5234, or via email at kathy.crocker@rbc.com. Of course, we financial advisors are also available and look forward to taking your calls (Steve: (503) 833-5228, Chris: (503) 833-5207, Marcia: (503) 833-5225, Kip: (503) 833-5239).