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Come gather 'round people wherever you roam
And admit that the waters around you have grown
And accept it that soon you'll be drenched to the bone.
If your time to you is worth savin',
Then you better start swimmin' or you'll sink like a stone,
For the times they are a-changin'.

Bob Dylan: From the album The Times They Are a-Changin, 1964

Dear Friends,

As you probably know, Bob Dylan became the first songwriter to win a Nobel Prize in Literature last November, drawing the praise of many while others expressed shock and amusement. Adding to the irony of this achievement, the enigmatic Dylan announced that due to pre-existing commitments, he would not be available to travel to Stockholm to attend the ceremony, speak for the required thirty minutes and accept his $1.5 million check in person. For the record, in the unlikely event the Prize Committee should elect to create a new category honoring Client Letters and choose to recognize your writer with an award, I am prepared to clear my calendar and attend the ceremony. Better still, I pre-agree to limit my comments to fifteen minutes or less. (No small sacrifice here.)

Dylan may not have gotten his Nobel priorities quite right, but his lyrics are perfect in describing what may be the future of bond *prices* in this country…as in *sinking like a stone.* In part because the bond market is relatively dull with prices and yields changing in increments as small as 1/100th of 1%, there is a tendency for this marketplace to mostly go unnoticed. When was the last time the evening news reported on bonds? And since nearly all the bonds/CDs we own mature in less than a year, why should we care? Aren't we pre-positioned to benefit from a rise in rates? Yes. However, a bear market in *any* asset class tends to put other classes such as real estate, stocks, bonds and commodities at risk as well. (While not causal, remember that the Great Recession of '07-'09 actually first began with a collapse in oil prices.) So, it's our view, with apologies to Mr. Dylan for corrupting his lyrics, the *times they are a-changin'.*

A Bond Bust?

People tend to think about bonds as a safe harbor. They are a place to park savings, collect interest, and wait for the borrower to send our money back. But bonds are also a basic building block of the economy. Debt helps to facilitate the purchase of homes, companies, building of factories, inventories and the acquisition of capital equipment ranging from computers to trucks and machines. Then, of course, there is the biggest issuer of all…governments. (Don't get me started.) It is therefore fair to think of borrowed money as a hybrid form of raw material which, of course, comes with a cost: interest. Like most costs, borrowers are thrilled when interest rates go down. This equation understandably tends to cause economies to expand when capital is cheap and readily available and contract when the opposite is the case. The nine year decline in rates since 2008, engineered by the Federal Reserve, was designed to have exactly this effect. It worked. Took a lot longer than expected with short-term rates eventually falling close to zero in this country and below zero in leading European economies and Japan. In recent months, evidence is mounting that this secular (not cyclical) decline in rates has come to an end.

It is actually correct to date the secular decline in rates back as far as *thirty years*. Some of you are old enough to remember teenage rates in 1985 when Pacific Power and Light offered five-year bonds at an

18% interest rate. This is not a typo. 18%. We sold 'em like hotcakes at a charity breakfast. Who needed stocks? At the same time, the ten-year US Treasury offered a yield of over 15%. From that peak in rates, the yield on the ten-year Treasury cratered recently at 1.37%. Putting this in dollar terms, an investment of *$10,000* returned all of $137 late last year as opposed to $1500 in 1985. Big difference. Over the past three months the ten-year Treasury has increased in yield to roughly 2.5%. As bond <u>prices</u> are inversely correlated to changes in interest rates, the increase in yield from 1.37% to 2.5% caused the market value of this bond to decline by nearly 8% to $920. If ten-year yields were to rise further from 2.5% to a more normal level of 4%, the same bond would fall further in price from $920 to $800 for a total decline of 20% from the peak on what we think of as a defensive instrument. A parallel change on a thirty-year Treasury would be far more devastating.

We have two points to make here. Longer dated bonds whether tax free or taxable may be more dangerous to own than most people understand. If you have any, call us. Secondly, as referred to previously, we view an end of the Great Bond Bull Market as creating headwinds for other asset classes, real estate in particular followed by stocks as well. Why? For real estate the answer is pretty obvious: higher rates mean higher monthly payments which eventually can force buyers to go down market or price them out entirely. Couple this with today's artificially high real estate prices engineered by the Federal Reserve's micro interest rate policy and you have the formula for a nasty downturn. Not of the magnitude of the Great Housing Bust due to less supply and tighter mortgage standards, but a downturn nonetheless. Interest rates can also relate to stocks in a parallel fashion. Fed policy in recent years was to force rates down so far that investors had little choice but to take on more risk in the form of owning things as opposed to lending (which is what we are doing when we buy CDs or bonds). It was the Fed's stated hope that spurring *demand* for riskier assets would push up prices and, with this appreciation, demand for goods and services in the entire economy. We are not in the business of forecasting the next 2,000 point move in the Dow. However we see the investment climate as having a diminished reward potential due to highly elevated asset prices coupled with increasing costs of capital. We intend to use the first quarter to reduce our overall risk exposure a bit, markets permitting.

Big Round Numbers

It is not clear whether Warren Buffett's greatest contribution is as an investor or as a modern day Will Rogers. Long-term readers know how fond we are of quoting him. We recently came across a gem which is germane as we assault yet another Big Round Number on the Dow: **20,000**. Warren offered this insight: *"What we learn from history is that people don't learn from history."*

In part because we humans accept breeching stock market benchmarks such as the Dow Jones as being meaningful (and oddly a reason to buy), we thought it would be fun to take a look at how things turned out a number of months to a year or more down the road from when the benchmark was breeched. It is sobering to admit that your writer was around to experience all of the following:

Year Breeched	Benchmark	Subsequent Level	Percentage Change
1972	1,000*	700	-30%
1987	2,500	1,800	-28%
1995	5,000	5,500	+10%
1999	10,000	7,200	-28%
2007	15,000	6,500	-57%
2017 ?	20,000**	??	??

* The Dow first touched 1000 on an intra-day basis in 1966 but failed to close there. It was not until <u>6 years later</u> that the average actually closed above 1000.

** We just missed by a fraction of a *point* trading thru 20,000 on 1/6/17

So, what we learn from history is that breeching benchmarks and the aftermath is comparable to kids eating their cake first and broccoli second. (No offense to our local farm-to-table broccoli growers intended.) In a statistical sense, it is noteworthy that stock market valuations as measured by prices in relation to earnings were substantially above average in all but one of these periods: you guessed it, 1995. That event was the one occasion when stocks did well following a Big Round Benchmark being achieved. And where does the near 20,000 Dow stand today in relation to prices to earnings? Top decile… meaning very expensive.

Finding the Needle in the Needlestack

At Spence Partners we tend to view our investment medium as a market of stocks as opposed to a stock market. In so doing, we see ourselves as providing homes for unloved stocks, one at a time. The problem today is that there are just not too many of them. An exception lies in the pill industry, a sector of the economy laden with controversy. As you know, health insurance is in complete disarray. Secondly, a handful of often highly indebted drug companies raised prices at eye-popping rates on patent-protected products. Then there was the issue of domestic drug producers merging with offshore companies largely to lower their income tax rates here in the States. Finally, there have been a number of big-time unanticipated failures of product in the late stages of development which meaningfully impacted future earnings of the companies concerned. Amid this kind of controversy, it would not surprise you to hear that we along with RBC's equity research analysts are finding some genuine bargains in this space. Stocks such as Gilead, GlaxoSmithKline, generic producer Teva and even more glamorous biotech stocks such as Allergan, Amgen and Biogen sell at valuations to earnings which are well under that of the overall stock market. Dividends in some cases are prodigious. Do we have special insight into how the systemic problems will work their way out? No. Do these companies provide desirable products? Yes. Are they well financed? Yes. Do pills make up less than 10% of US healthcare costs? Yes. Are there some bad actors in the industry? Yes. Is there room for the industry to take a hit as issues are resolved and still make money for their holders? We believe so. While it may take awhile for things to sort their way out, in some respects pharma sits where the energy business was just over a year ago with oil under $26 and no hope in sight. Next stop? $52 a barrel and leading energy stocks up 50% and more. The road traveled by contrarians is commonly controversial, never easy but often rewarding.

In closing, please accept our best wishes for a healthy and prosperous New Year. We look forward to speaking with you over the next few weeks. Save up those questions!

Warmest regards,

Steve Spence	Marcia Hull	Kip Acheson	Chris Klavins
Senior Vice President	First Vice President	First Vice President	First Vice President
Sr. Portfolio Manager-Focus	Sr. Portfolio Manager-Focus	Sr. Portfolio Manager-Focus	Sr. Portfolio Manager-Focus
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