Quarterly Newsletter - January 2016

January 15, 2016

Dear client,

We are in a period of market volatility ? that is clear. It seems scary. Is it scary? There is certainly a way of framing it, thinking about it that can make it scary. It is at the beginning of the year ? so perhaps it will set the pattern for the whole year. And it seems so fast ? so odd ? and so violent.

Framing is to put a frame or narrative around something and then point at it and then more or less just shout. We have some of that now, scare quote type volatility. The TV or newspaper shouts ? as loud as they can, or says it very softly and calmly, which makes it even worse ? ?Dow down 1000 points (about 6.5%) in the last week? or ?the worst start of the year ever in the history of the stock market.? It is completely normal and natural to then project the narrative out. This is called recency ? taking the market action for a recent and normally pretty short (one week is after all not very long) time period and extending it into the indefinite future. Catastrophic losses then loom and real fear arrives.

But, there have been single days, not whole weeks but rather single days, in which the Dow lost more than 7%. On October 19, 1987 the Dow lost 23%, in one single day. There were several single days during the 2007-2009 crash in which the market lost more than 7%. Did we have a depression? We did not. Did the market never recover? No ? it did recover. And investors who refused to panic were rewarded, while those who sold out regretted doing so.

Could this be the beginning of another 2007-2009 type market crash ? a crash in which the S&P lost more than 50%? That seems very unlikely, but of course it could be. Anything can happen in frightened markets. The Fed has raised rates in the face of a not very strong U.S. economy which seems to be sort of an ideological thing to do. They just really want to get rates up, to preserve their ?credibility? their notes say, and apparently to heck with everything and everybody else. And growth in China is slowing as they move to a less export and more domestic consumption driven economy. As growth slows there is a temptation to either devalue (which they are doing) and/or allow unpayable debt to pile up in the banks. These may lead to a currency or debt crisis.

But none of this really worries us. These are just standard problems. The world always has problems. If any of them happens the markets will go down (a lot and quickly probably) and we will sell bonds and buy stocks, just as we did in 2007-2009.

The reason we are not worried is that none of this involves the possibility of a catastrophic failure of the U.S. or world banking system. Just as that possibility did not exist in 2007-2009 either. This is due to the existence of central banks (printers of the currency) and to the theoretical work of Milton Friedman. Friedman showed that the 1929 depression was the work of the U.S. Federal Reserve in refusing to bail out the banks. It was this refusal, not the 1929 stock market crash that caused the depression. The stock market collapse frightened people. They needed or wanted their money (currency, cash) from their local bank. The Federal Reserve simply allowed banks to be run by their depositors and then to just collapse when they ran out of cash. They refused to print new currency and recapitalize the banks. Flat refused. This was an act of utter and total lunacy because when the banks failed they took with them payrolls for local companies ? which had to then immediately go bust. This spiraled out of control and the whole economy collapsed. It is simply beyond obvious that no central bank would ever do anything remotely like that again. Banks may fail but deposits are guaranteed, guaranteed by the institution that prints the currency. This makes all the difference. Bank failure no longer shrinks the money supply. Therefore the economy will recover even from a large banking failure (see 2007-2009) and so also will the stock market. Down, yes. Down and out? No. The market will recover and life will go on.

Our confidence in the ability of government to protect deposits comes from the existence of Big Powerful Government. The U.S. has that and China has that. Europe does not. Small government or weak government, lacking the real power to tax and/or lacking a big economy, cannot protect deposits. Big Muscular Government, with taxation authority and big muscular central banks can and will. They can absolutely guarantee deposits and be believed. It is the combination of the Federal Reserve and the FDIC that makes all the rest standard stuff. They have our backs. The Fed prints the currency. The FDIC uses the currency (if they have to) to guarantee deposits.

But our idea of standard stuff certainly does include 10 or 20 or 30 percent market declines. In fact we treated the 2007-2009 crash as standard stuff as well. We used our standard method ? rebalance. Sell bonds and buy stocks. We simply assumed that the economy and the markets would eventually recover from that fall. We assumed that because we believed the FDIC could and would protect, not the banks but the bank deposits. And so they did. Banks went bust but the deposits simply moved to other banks. And both the economy and markets did recover. We believe the markets will never again go down and then stay down as they did from 1929 through 1932. We believe Big Government prevents this. But they can most certainly go down.

Please recall, however, that they can also go up. If things go badly for the U.S. economy the Federal Reserve will very soon be back in the business of cutting rates and attempting to increase inflation. The U.S. stock market would like that. There is much worry about a Chinese ?hard landing? and an export of Chinese deflation through currency devaluation. But China could get confidence, growth, and inflation going by using their large amount of reserves not to defend the currency but rather to do quantitative easing to buy and retire bad bank loans. The Chinese government clearly has the money and political muscle to do this. If this were to happen the Chinese domestic money supply would rise rather than continue to fall and world stock markets would likely do extremely well.

If the recent action of the markets has worried you please come see us. We can review the allocation of your portfolio within the context of your overall financial plan. We have developed a database that details the inflation adjusted returns for stocks and for bonds for any monthly time period since 1927. The data clearly illustrates the volatility risk of stocks and the inflation risk of bonds and the effect these risks can have on your portfolio over time.

Equity returns are made by long term equity owners. That is you and us. We will buy the markets and asset classes that become cheaper. We believe this is a reasonable, and for us the only reasonable, way to invest.

Please be sure to contact us with any questions. And Happy New Year to you and yours.

Jim John Richard & Ryan