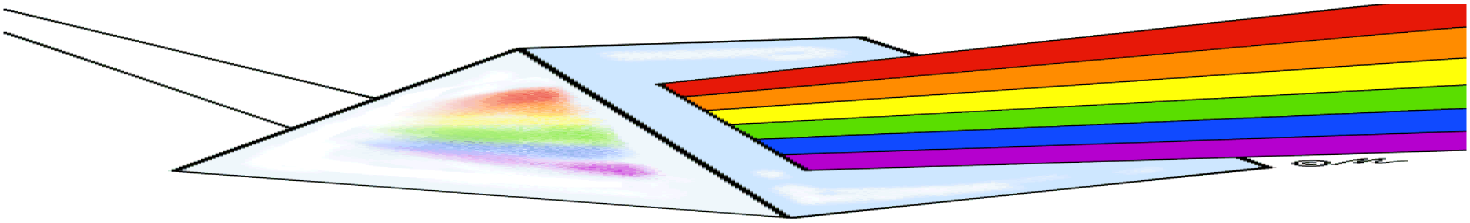

Prism – The Value Architects Newsletter - May 2017 Edition

Prisms have always been a source of wonder and fascination as they bend light into its components, revealing its infinite spectrum. Investments can be like a prism. What you see depends on how you turn the glass. What others see as white is actually a rainbow of colors packed into a small space. That's why we have decided to call our newsletter 'Prism'.

Thinking about the Economy-Looking at Q1

***Believe those who are seeking the truth. Doubt those who find it*- Andre Gide**

The biggest question on our minds and most investors is how US public policy will play out under President Trump. Optimists seem to outnumber pessimists as equities have performed well, the US dollar has risen, and bond yields have moved up. First quarter GDP statistics were disappointing, with real growth of only 0.7% annualized (real GDP increased by a mere $29 billion in the quarter, almost a rounding error). However, real growth for the 12 months ended March was 1.9%, only modestly less than the 2.1% annualized growth rate for the current business cycle expansion. More interesting, perhaps, was the rate of inflation as measured by the GDP deflator (the broadest measure of inflation available): 2.3% annualized for the first quarter and 2.0% for the past 12 months. By this measure, the Fed has achieved its target inflation goal, and is fully justified in raising short-term interest rates. The brightest spot in the quarter was a 12% annualized jump in gross private fixed investment, since weak business investment has been the root cause of the current recovery's dismal, 2.1% annualized pace of growth. This may mark the beginnings of a pickup in growth in the years ahead, especially if the President is able to slash the corporate tax rate as he proposes.

The general lack of business dynamism in this recovery has been well-documented. The Bureau of Labor Statistics, for example, shows that the number of jobs created by new businesses (those less than one year old) has declined from upwards of 4 million in 1994 to 3 million in 2015, partly because of a slow rate of new business formation.

Whether this has been related to a lack of credit availability or an increased regulatory burden (likely both), the fact is that small and medium-sized businesses (those with less than 500 employees) have not led the pack in hiring throughout much of this expansion, which is quite abnormal. A recent and encouraging development, then, has been the long-awaited emergence of hiring among small employers.

April marked the 79th straight month of job growth; by far the longest such streak on record. The US has added 15 million jobs over that period. When the trend began in October 2010, the unemployment rate stood at 9.4% (contrast with the just announced 4.4%) and would have been even higher if economists counted the millions of Americans who had stopped looking for work. Perhaps more remarkable than the recovery's length has been its resilience. Time and again, one or two weak months of hiring have sparked fears that the recovery was nearing its end; time and again, job growth rebounded. The past two months are a good example: Hiring slowed sharply in March, when employers added just 79,000 jobs, but quickly rebounded in April, adding 211,000.

Globally, we have seen a strong pickup in growth and are seeing for the first time in some years, a synchronized recovery. Central banks are becoming less accommodative both here and in China where the Peoples Bank of China has put restrictions on lending to the property sector and money market rates have moved higher in order to dampen leverage in the financial system. The Eurozone economy seems to be picking up speed, even as America went through a Q1 soft spot with the EZ growing around 2% versus the US at 0.7%. A jump in car sales in March saw Europe, as a whole; overtake the US as the world's second-largest market (behind China). Euro-zone manufacturing grew at its fastest pace for six years in April, according to the purchasing managers' index, a closely watched gauge of economic activity. The corresponding index for America fell. Though the Fed has started to very slowly raise interest rates, the ECB is keeping its pedal to the medal.

Finally, addressing trade, we note that the US has declared its first trade war…against its friendly neighbor to the north, heeding President Trump's frequent cries of "America First" in a misguided effort to save US jobs. Politicians are constantly tempted to go to war with markets in a bid to win votes. When they do, they and their constituencies always lose. A market are a force of nature, and attempts to use the state's police powers to crush them invariably end in misery. Americans lose jobs to global competition, but also to domestic competition and, most importantly, to automation and technological advancement as old industries disappear and new ones form. There's dislocation, but today, despite everything, unemployment is 4.4% of the workforce, close to the 4% statistical definition of full employment.

As always, we thank you for your confidence and trust!

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