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REGISTERED INVESTMENT ADVISERS / INVESTMENT COUNSEL

STRATEGIC INSIGHT

# FOCUS, KEEP YOUR EYE ON THE BALL…

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No, I'm not giving a golf, batting, or service return lesson. Rather, I'm sharing my daily message to myself as I invariably wake to news of another tweet, another missile launch, another White House resignation, or another riot or terrorist attack. The financial news is equally cloudy, with speculation about a tax cut, a budget, debt ceiling, or Janet Yellen interest rate hike and how any (or all) of this will affect the stock and bond market or the value of the dollar. All of this is pertinent noise, but it is just that…noise.

Most important for us at Cadinha & Co. is to remember our view of the world and to relate any and all noise to that view. By repeatedly adhering to this discipline, each news item (a bit of noise) can be digested with some meaningful perspective.

*First and foremost* is our belief that we are in the end phase of a long term debt cycle. This debt cycle began during World War II, and has since been gaining momentum around the world. The war was initially financed with debt, and the reconstruction of damaged and lost societies gave a "jump start" to this borrowing binge by all. Political leaders of all kinds have one thing in common: they want to deliver "benefits" to their people. These "benefits" can range from social programs (free healthcare, free retirement support, free education, free babysitting, etc.) to new roads, new military strength, power systems, water systems, highways, harbors and yes, government jobs. Since World War II, leaders have been actively borrowing for this purpose.

How else can leaders guarantee themselves continued power and influence? Americans have recently added food and housing subsidies, as well as an "unearned income tax credit" (an outright annual monetary gift) for low income citizens. All of this has been financed with higher taxes and more borrowing. This global debt cycle has risen to a point where aggregate borrowings by government, businesses and individuals approach $250 trillion without any plan to pay it back.

The end phase of a debt cycle is characterized by an ever-increasing risk of default. Someone eventually can't pay. Countries, businesses, various institutions and individuals begin experiencing difficulty in making ends meet. When the mortgage crises hit eight years ago, defaulting homeowners gave their properties back to the banks (lenders), and this form of default caused a crash in home prices, as well as stock and commodity prices.

The Federal Reserve, along with other Central Banks around the world responded by printing money, lowering rates to near zero (or below zero in some cases) in order to stop a more serious decline.

They were somewhat successful in heading off a massive liquidation, but to the disappointment of many, there was little if any economic growth generated and very few well-paying jobs as a result.

Another truism in a late phase debt cycle is that increased borrowings and lower interest rates have a less stimulative effect on growth as the overall debt burden increases in size. The Federal Reserve literally begins "pushing on a string" with minimum result.

Citizens begin voicing frustration publically and emotions run high as personal financial stress begins taking its toll. In our last election Americans opted for a new policy direction, away from large government, higher taxes, and increased borrowings. The implementation of new policies, however, has proven to be difficult as more and more Americans, who have become dependent on government spending over the decades, openly resist the change. This is not surprising, as stress levels also run high in the late phase of a debt cycle.

It must be remembered that for every borrower there is a lender. The lending class (the wealthy) become disliked for their apparent prosperity, and the seeds of political envy are sown. The media plays to this inclination as class warfare rears its ugly head and the noise gets louder. Recently released data shows that credit card balances and student loan balances in the U.S. each exceed $1 trillion. Last week, news headlines revealed that 75% of American families are living "paycheck to paycheck." Let's not forget China, where capital controls have recently been installed to stem the outflow of money. Because of the runaway debt, the Chinese leadership announced that debt default in China will now automatically be considered malfeasance, punishable as a crime. This kind of move does not engender growth.

The facts and the noise confirm our view of a late phase debt cycle. To avoid a disastrous end, it's become imperative that economic policies be put in place to foster growth that can only come from aggressive capital investment. In that regard, tax cuts become critical, as does further de-regulation of business. If these policies are put in place, we could experience much higher growth, not only in profits, but in tax revenues as well. This change in direction can quickly halt and change the debt cycle, giving us a new era of prosperity and civil peace.

*The second critical part of our world view* is to remember that the leadership in the White House, Senate and House of Representatives all subscribe to this type of change. This is a new and positive backdrop for investors compared to the previous 10 years, when aggregate debt doubled, regulations were instituted to an all-time high, and new expensive social programs were put in place.

Whether a new change of direction can be put in place becomes the important watchful concern. And if change comes, will it be the right, meaningful type of change to provide an escape from this late phase debt cycle, or will it be more of the same, disguised under the cloak of change?

There is no doubt that change will tip the "seesaw" of valuation between various asset classes. Change will likely effect interest rates and currency exchange rates as well. The specifics, however, will create new trends and new investment leadership.

Our challenge going forward is to monitor this process and to maintain a high degree of patience in doing so. Once change becomes evident and clear, we then can study the specifics, or particulars, to determine who will be the winners and who will be the losers.

For example, not all tax cuts will grow the economy at the same rate. For that matter, not all tax cuts will grow the economy. A tax cut for just the middle class does very little for economic growth. When coupled with a tax hike on the upper 1%, it could actually hurt the economy. This kind of a "cut" is being advocated as a compromise to popular social arguments coming from the politics of envy. The most critical element of a meaningful tax cut is the highest marginal rate, for it is that rate which is used to calculate after tax returns for all investors. If the after tax returns are lower, there will likely be no new investment forthcoming. In order to stop the debt cycle, we critically need capital investment: "no ifs, ands, or buts." American businesses are sitting on trillions of dollars in cash, fearful of higher regulations or taxes, which has been their experience over the last 10 years. This is the key reason why economic growth and meaningful jobs have been so hard to come by. When studying tax cuts, we must also look closely at deductions. Deductions in the code simply represent government subsidies for specific economic activity. The fact that corporate interest expense, as an example, is deductible means that government subsidizes corporate borrowing activity. The loss of this deduction will change the incentive for borrowing and probably effect overall interest rates. Same goes for the deductibility of home mortgage interest. Clearly corporations with high debt levels carry more risk in this "change" environment.

The present deductibility of state and county income taxes on the federal return means that our federal government is favoring tax payers and government in high tax states over those in low tax states. Eliminating this deduction will exert short-term hardships upon high tax states and likely change the credit rating for the issuance of new municipal bonds. Yes, this is a current consideration for tax reform.

Without adding to the endless list of consequences resulting from change, let me make a key point. We have a good chance for meaningful change, which we have not had for many years. This is a distinct positive. Today's environment is infinitely better than we've had for 10 years. Deregulation combined with a well-structured tax policy could increase after-tax returns to corporate shareholders by as much as 80%, so it's worth "staying in the game," but it's not worth risking one's life's savings "across the board" until we know that change is eminent and have had a chance to study the specifics. A knowledgeable investment move will have a distinct advantage over a careless, emotional move.

Looking back, a client who invested with us on our first day of business 38 years ago, who withdrew no money, and added no money, has realized a return on capital in excess of 22x. (Actually such a client doesn't really exist because all clients invariably withdraw or add money over a 38-year span.) The numbers, nevertheless, bear this out. Our process has always been conservative, macro-oriented, and deliberate in nature. I can assure you that after all these years, we are not about to change our spots by "jumping the gun" to aggressively chase returns. Instead, we are patiently keeping our eye on the ball. We will know soon enough whether there will be meaningful change in our country and if so, what that change will mean. As always, we appreciate your continued confidence.

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