Capital
INVESTMENT SERVICES
of America, Inc.
Simple Sophisticated Effective

Perspective

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In This Issue . . .

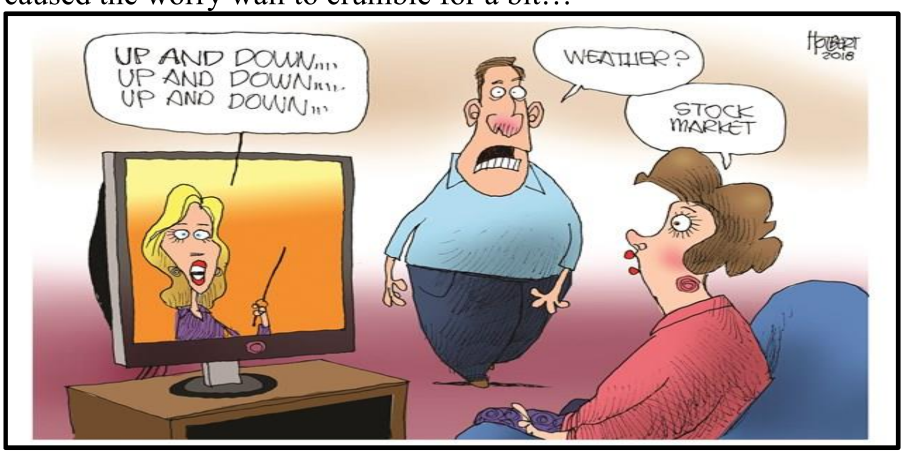
- ✓ How many *insecurities* traded today on Wall Street?
- ✓ Maybe it's called *Wall* Street because of the perpetual wall of investment worries.
- ✓ The price of rewarding returns is enduring volatility along the way.
- ✓ The "new normal" mindset of "secular stagnation" remains deeply engrained.
- ✓ Until the next recession, the stock market should be able to climb the worry wall as it's done since 2009.
- ✓ Lots of new "tools" available that can spread the benefits of technology.
- ✓ The wall always provides lots of "yeah but…" issues.
- ✓ Trade tension with China is about "intangible assets" (technology and IP) in our estimation.
- ✓ Hard to protect these intangible assets yet it's where the real value lies in digital capitalism.
- ✓ Fed's not likely to be guilty of "murder" anytime soon.

The Wall

Each day Wall Street tallies the number and dollar value of investment securities traded on the financial exchanges. But what Wall Street is really good at is trading insecurities. "How many insecurities traded today?"[1]

From Election Day 2016 through the first few weeks of this year, the U.S. stock market displayed very little downside volatility. There were numerous "insecurities" traded along the way, but the *market climbed the wall of worries* and powered higher.

Perhaps the combination of rewarding returns and relative calm even caused the worry wall to crumble for a bit…



…but no longer! Calm has given way to volatility, and Wall Street has lots of insecurities to trade of late. To the wall of worry many "bricks" have been added.

[1]*Maxims of Wall Street*, Mark Skousen, Editor

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Chief among the worries are:

- Potential trade wars
- Federal Reserve interest rate hikes
- Rising inflation
- Stock valuations and memories of tech wreck of 2000
- Ballooning budget deficits
- The stream of unpredictable tweets from the President
- Facebook issues with digital privacy and security
- General angst about the future and technology
- Secession ruminations within the Eurozone

Can the stock market climb the current formidable wall of worries, or is the volatility perhaps signaling a major negative turning point for the economy and markets?

Here's our perspective on these questions.

How does the stock market climb the worry wall in the first place?

The investment world is never free of worries. If one waits for a definitive all-clear signal before investing, they'll be waiting forever.

"Sure thing", no-risk, high-reward, investments simply do not exist. As we've noted on prior occasions, enduring volatility and some risk are the prices to pay for rewarding investment returns.

Since the future is always uncertain, investing comes down to assessing probabilities. We believe the way to maximize the probability of success when assessing the investment environment is to focus on the underlying fundamentals—namely, the outlook for corporate earnings and economic trends.

Emotionally responding to Wall Street's daily trading of insecurities is a recipe for "selling low" and "buying high", in our experience. Behaving this way is not part of the playbook for maximizing the probability of investment success.

This is not to imply, by the way, that our guts don't churn when things are turbulent. Of course they do. But, emotions are typically an investor's arch enemy. The message from Kipling's[2] poem; "keep your head when those all about you are losing theirs", is worthwhile for investors to remember and, likely, one of the keys to Warren Buffett's investment success over his career.

[2] *"If"*, Rudyard Kipling

So how does the stock market climb the wall of worries? It does so when things turn out better than expected.

Notice, we didn't say, things must turn out "great" or even "good". If good or great happens, that's wonderful. But, "better than expected" is key.

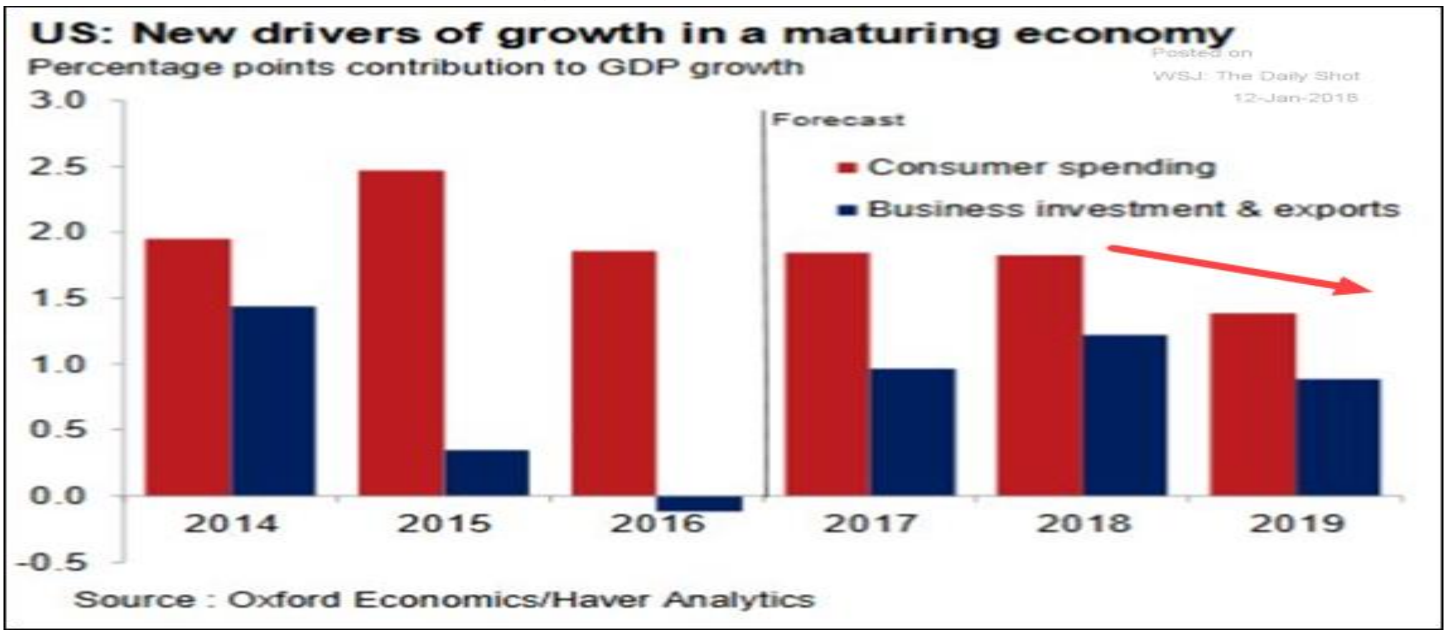
Since the Financial Panic of 2008, many have been expecting that a Great Depression re-run was just around the corner. Gloom and doom prognostications have found plenty of fertile ground from which to spring forth in the climate of fear, uncertainty, doubt and insecurity that's characterized much of the world over the past 10 years.

Reality hasn't had a very high expectations bar to clear with expectations so glum. It's not been a smooth ride, but the stock market has been able to climb the wall of worry ever since.

More climbing ahead?

We think still more climbing remains ahead for many stocks. The so-called "new normal" mindset of "secular stagnation" with a precarious economy that it could collapse any moment, remains deeply embedded in the collective investor psyche, in our estimation.

Chart 1: Typical "new normal" economic forecast

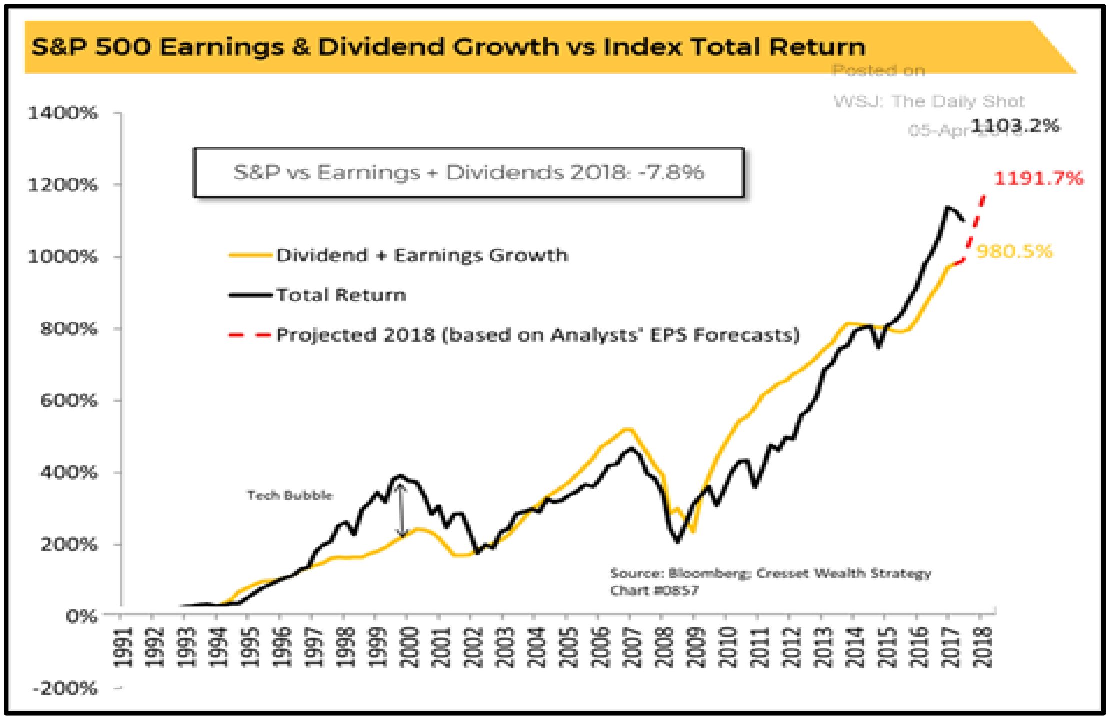


Our assessments of the prospects for economic expansion and corporate earnings lead us to believe "reality" will again exceed the "new normal" expectations bar.

To be clear, there will come a time when the outlook and underlying fundamentals will no longer be poised to deliver favorable surprises relative to expectations. We just don't believe such a situation is yet on the horizon.

The underlying fundamentals should get an important boost with the recent tax cuts and an easing in business regulation. Corporate earnings and cash flows should remain in a solid uptrend (See Chart 2 on the following page).

Chart 2: Fundamentals underlie stock prices



Economic incentives matter more than seems generally appreciated, and the corporate tax cuts materially increase the incentives for expanding business investment and work. Coupled with the emerging technology productivity "tools" that we've been discussing for some time now, and the ingredients for economic growth and continued economic resiliency are in place.

Business investment—new urgency

Businesses have additional reasons to increase investment spending beyond the tax cuts. Call it the Amazon effect. More businesses fear becoming disrupted as the digital economy continues to evolve. The sense of urgency for businesses to respond has increased.

> "***Five years have seldom passed away in which some book or pamphlet has not been published…pretending to demonstrate that the wealth of the nation was fast declining, that the country was depopulated, agriculture neglected, manufacture decaying and trade undone".***
>
> Adam Smith, The Wealth of Nations, Published in 1776

Fortunately, many new productivity-enhancing tools are emerging which should help enable companies to respond and compete. These tools include such things as:

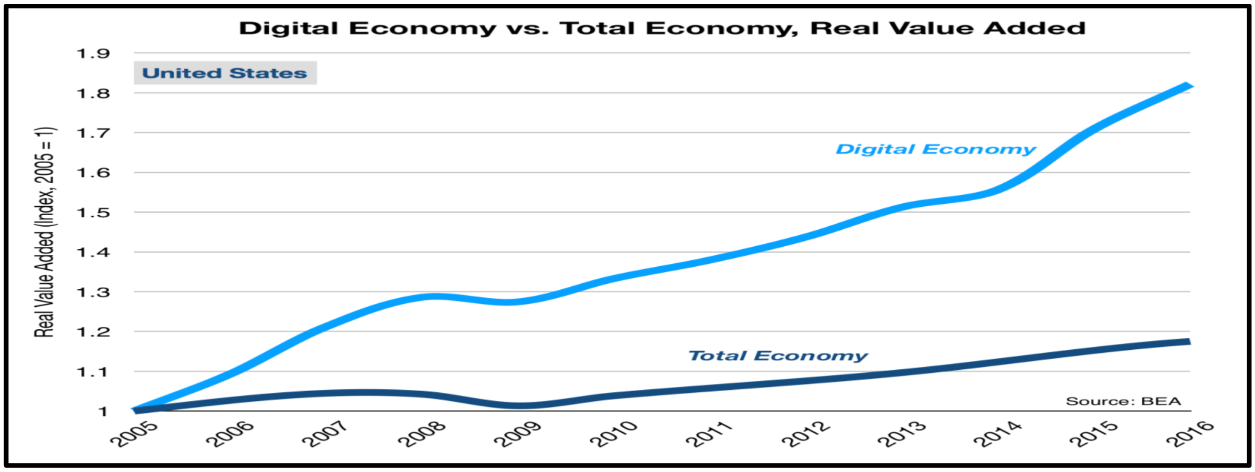
- Big data
- Cloud computing
- Software as a service
- Internet of things
- Digital twins
- Artificial Intelligence
- 5G
- Blockchain
- Quantum computing

Increased business investment has many favorable economic and investment implications:

1. Since productivity growth powers advances in the standard of living, businesses employing new productivity enhancing tools is a profoundly good thing.

2. The saying "*the future is already here, it's just not evenly distributed*", suggests that until technologies are more broadly diffused, associated benefits are concentrated among only a few. Increased and broad adaption will help spread the benefits. (Chart 3).

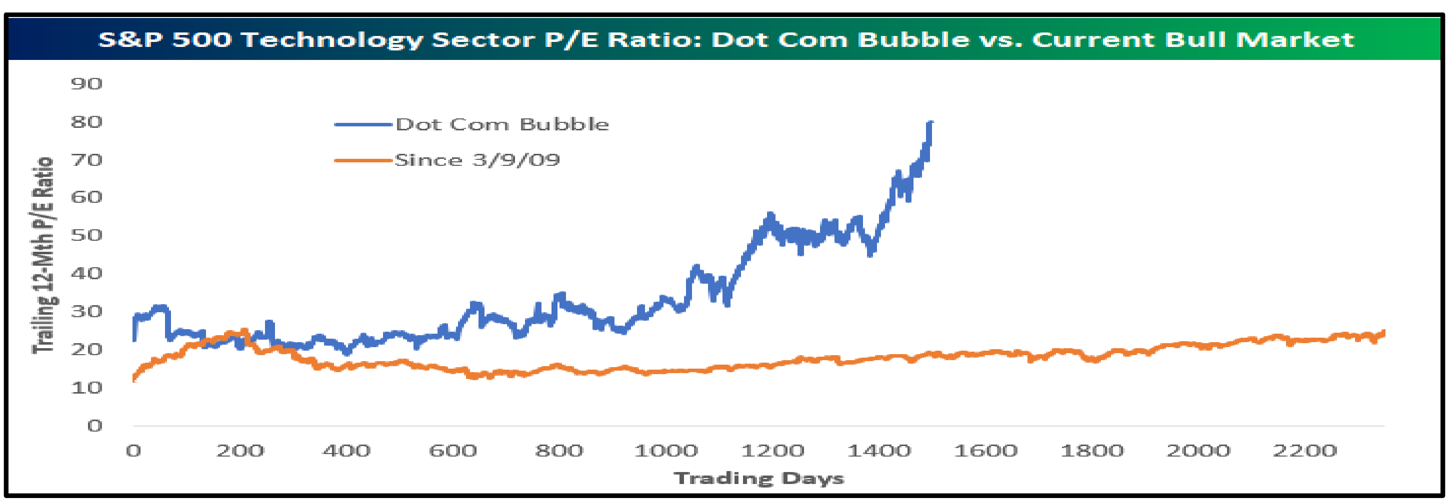
Chart 3: Lots of opportunities for companies to increase business value by applying new productivity tools (Source: Defining and Measuring the Digital Economy, BEA, 3/15/18)



3. A number of our portfolio companies are at the forefront of providing the new tools. As business investment spending increases, the sales, earnings and cash flows of these companies should benefit.

One of the *insecurities* we noted earlier is concern that technology stock valuations puts them at risk of repeating the Dot Com crash and burn that occurred back at the turn of the New Millennium. Chart 4 suggests this concern is exaggerated.

Chart 4: Looks much different to us
(Source: Bespoke Investment Group)



Yeah, but (#1)…

But what about other wall of worry concerns? Like the potential for a trade war with China. Wouldn't that kill the economic expansion?

With visions of the Smoot Hawley Tariffs and damage it helped create during the 1930s, wouldn't a trade war with China change this picture and seriously threaten the economic expansion and corporate earnings? Aren't "we" playing with fire here?

A trade war like Smoot Hawley would indeed be bad. Very bad. So, yes, risks exist.

We don't believe this will escalate to a disastrous trade war, however. We remind ourselves that this is The *Art of the Deal* president. Starting negotiations from what may appear to many as an "extreme" position may well be part of the process to a deal.

To us, the critical aspect in the trade dispute revolves around technology. Transfers of technology and intellectual property (IP) from U.S. companies to China by whatever means is a big issue.

With the emergence of the digital economy—or as some are calling *digital capitalism*—the most valuable strategic assets and competitive advantages increasing flow from "intangibles", like technology and IP. Chinese leadership is well aware of this trend, and their master industrial plan includes being a leader of these trends within the next few years.

Cartoon: Trade wars are mutually destructive; cartoon should also depict China's leader Xi Jinping at the receiving end of a similarly shaped canon.

A company's physical assets can be locked up and monitored closely. By contrast, intangible assets are incredibly hard to protect. The stakes are indeed high, on multiple dimensions.

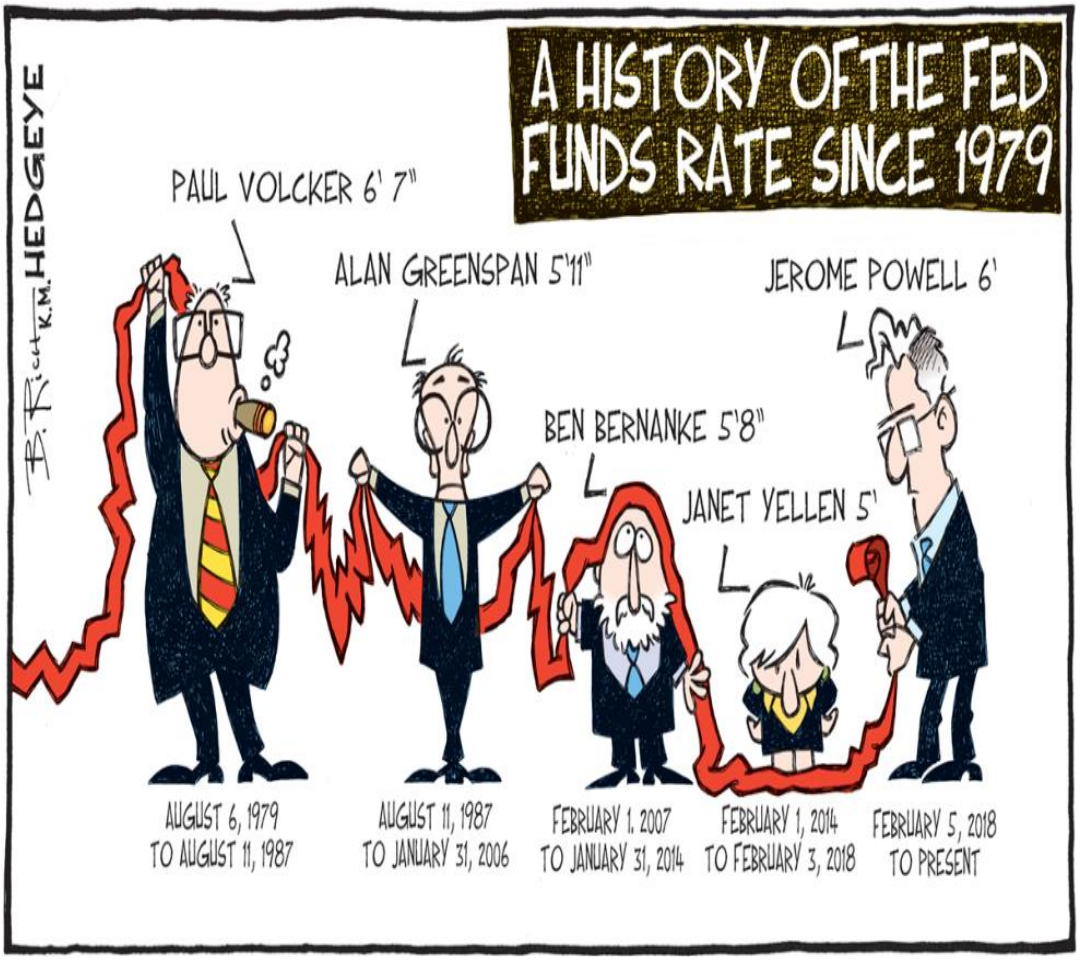
Trade tensions may well become more intense. We wouldn't be shocked to see still more rows added to the wall of worry. But, with mutually assured destruction, negotiations remain the probable outcome.

Yeah, but (#2)…

What about the Federal Reserve (Fed) raising interest rates and tightening monetary policy? As economist Rudy Dornbush once noted, U.S. expansions don't die of old age. "*Every one of them was murdered by the Federal Reserve"*.

Is this expansion at risk of being murdered by the Fed?

Cartoon: New interest rate forecasting tool—height of the Federal Reserve Chairperson?



We believe the Fed will indeed play a role in the next economic downturn…but that's likely some time off into the future.

And remember, context really matters when it comes to the Fed's current actions. They held interest rates under their control for 8 years at 0%! While they have indeed raised rates, their starting point was from an unprecedented (and incredibly low) level.

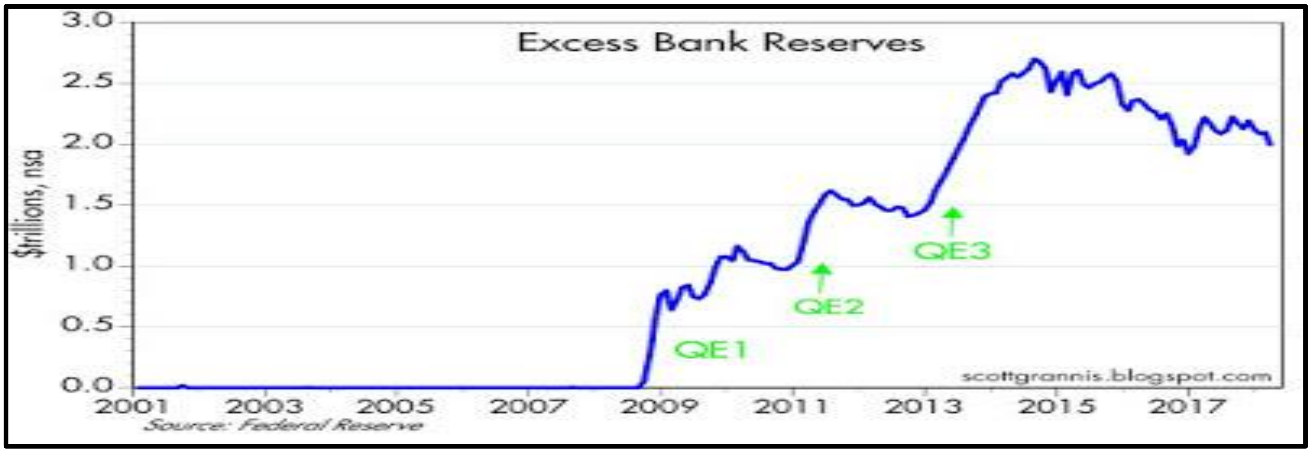
Furthermore, as part of its crisis monetary policy, the Fed flooded the banking system with liquidity, most noticeably in the form of "excess reserves" held on bank balance sheets. Chart 5 (on the following page) reflects the situation.

In the past, the Fed has addressed worrisome excesses (inflation and/or debt) by starving the financial system of liquidity. This would ultimately "murder" the expansion.

Yes, excess bank reserves have declined from a peak of about \$2.5 trillion as the Fed ended its bond buying program ("QE") a few years ago. However, with excess reserves at \$2 trillion, it is hard to conclude the economy is being starved of liquidity. By the way, prior to 2008, excess reserves were regularly around zero.

We still believe former Fed Vice Chair Stanley Fischer's description of their policy as having moved from "*ultra-expansionary to extremely expansionary policy*" remains an accurate depiction of the Fed's stance.

Chart 5: Fed policy remains a long way from being "tight"



Yeah, but (#3)…
What about inflation? Isn't it going to heat up if the economy does improve?

We do not believe the economy is terribly inflation prone at this time. Demographics (relatively slow population growth), technology, and the emergence of digital capitalism will likely keep a lid on inflationary pressures. Those excess reserves are likely to remain on bank balance sheets in sizable magnitudes for quite some time and not be converted into inflation's fuel via robust loan demand.

The probability is inflation will tick higher, but we expect it to remain relatively low. It is not likely to become a troubling excess that provokes the Fed to jump on the monetary breaks anytime soon.

We do, however, have continued concerns about the bond market's ability to weather even a modest rise in inflation. With yields so low, there's little to cushion bond investors. Our assessments continue to suggest that the best risk/reward profile in the bond market rests in short maturity and floating rate instruments.

Yeah, but (#4, 5, 6, 7, 8,…1,000 etc.)…
We did not address all the bricks within the current wall of worry in this *Perspective*. Rest assured, we and all investors, will be wrestling with them in the future. After all, worries and the wall will always exist.

But until the current economic expansion and the associated uptrend in corporate earnings are at material risk of ending, the stock market should be able to climb the wall. Climbing will be a bumpy process for sure, but the rewards for investors should be well worth it.

Established in 1981, *Capital Investment Services of America, Inc.* is a Milwaukee, WI-based independent investment counsel providing custom-tailored portfolio management to individuals, businesses, and charitable institutions.

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