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OBSERVATIONS ON THE MARKET

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Investing is an art, not a science. If it was a science, the numbers would make sense and it would be predictable. Throw enough time into the equation, and it is predictable, it even becomes a science. How much time you ask? Sometimes it's a few weeks, sometimes it's a decade. It feels like we are in the 'art' phase of the investment cycle.

Uncertainty is running rampant. Britain votes to leave the European union, and within 24 hours we find out they have no plan on how to leave. The economy continues to struggle to grow enough for the Fed to move interest rates higher by just .25%, that is uncertainty. In politics, we have two candidates, and neither one appears suitable to lead the country. Global terrorism is on the rise with no clear plan to reverse the trend. Corporate earnings are down about 15% from their highs. Fortunately, almost all of the decline is related to the oil sector. Unemployment is low, however, real median incomes in the U.S. are actually lower now than they were in 2000. Then there is the public debt that continues to march higher. This all leads to an uneasiness. Things just aren't quite right. This all leads to: Why is the stock market doing so well?

The market is never focused on what is, but on what will be. Let us start with GDP. In 2008, the economy produced $15 trillion of goods and services. Through the second quarter of 2016, the economy has grown to $16.5 trillion, 10% higher. Earnings for the S&P 500 were at $91 in 2008, and were up to $114 in 2014. They had grown by 25%. Energy is responsible for most of the current decline. Johnson & Johnson sells more band aids, PepsiCo sells more Pepsi and Fritos, and Apple sells more iPhones. It is true that the market is now 38% higher than the high before 2008, which appears to have outpaced what the economy and what earnings have done. However, that can be attributable to a few points.

One, earnings would be higher if the oil sector was not down 15%. The market which is always anticipating the future, is looking for a recovery in earnings. Plus, investors are looking for higher overall earnings from a slightly improving economy. Second, most of the outsized market gain is most likely attributable to interest rates. With the likely scenario that interest rates are going to remain low for the foreseeable future, earnings and dividends are worth more. The possibility of a .25% rate increase really means nothing. Long-term financing costs continue to be very low. Germany's 10-year bond is still slightly negative, which brings up another point.

In last month's letter, there was a reference that investors had to pay to hold a bond that is issued at a negative interest rate. That is not the case. They are actually issued at a slight premium, say $1,020, and then mature at $1,000. There are no interest checks coming in the mail, nor do you as an investor have to pay any interest rate payments. It is simply a guaranteed loss the day you buy it. Why you may ask would anyone knowingly enter into the certainty of losing money? Because investors (read fools) are speculating that they can sell it to someone else at a slightly higher guaranteed loss. It sort-of sounds like a Ponzi scheme, but it surely isn't because global governments invented this game. Beware of investments tied to very low interest rates. There is an argument that the bond market is in a bubble.

The stock market is also at all-time highs. Usually there is euphoria building as investors scramble to climb on board. That hasn't appeared to have happened yet. It seems like there is caution, everyone is waiting for the other shoe to drop. There is a Wall Street saying: "Markets climb a wall of worry." We have plenty to worry about.