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OBSERVATIONS ON THE MARKET

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This letter will be what the title suggests, various observations of what has happened over the last few months. The best place to start is the bond market, because that is what seemed to set off what has turned out to be a wild February.

The ten-year Treasury Bond, which is the center of the universe for the bond market, started the year at a yield of 2.45%. It is now at 2.85%. Corporate bonds as well as the high yield debt (otherwise known as junk) also declined. This means that the asset that is supposed to protect you and be your safe money, was not so safe. When yields go up, bond prices go down. Inflation was the culprit. Investors finally decided that maybe prices will start rising a little faster. When you start with such a low yield like 2.45% for ten years, it doesn't take much to create losses. An increase of just .4% wipes out more than one year's interest. If this is in fact the beginning of a multi-year cycle, interest rate cycles are historically measured in decades, 2.85% still doesn't give you much protection. However, one month's data does not a trend make.

One of the key narratives in the market has been; there are no alternatives. Suddenly, the bond market looks like a slightly better alternative than previously and we see what happens, the stock market becomes a casualty of higher interest rates. The question becomes, did they really move high enough? We have had similar valuations of the S&P 500 trading at 18 times earnings, and interest rates were twice as high as they are today. It seems a little ridiculous that a .4% increase in yields would drive the market down by 10% in about a week's time. It would appear interest rates were not the only culprit. Investors just decided that the economic data is not so docile and were spooked. There is always a risk that trends do eventually reverse themselves, so investors started taking a second look. In today's age of instantaneous news feeds, a second look takes about … a second. While the market was digesting higher interest rates, earnings estimates moved higher for 2018. The estimates for S&P 500 are now up to $156 from $145 at the end of December. This is largely due to lower corporate tax rates. This could be the reason we are experiencing such a quick recovery.

On the other hand, the oil market doesn't seem to get any respect lately. If you haven't been paying attention, oil is back up to $64 per barrel. Just six months ago it was in the $40's. Last year, all the prognosticators didn't see oil much over $50 for years to come. Without the usual fanfare, we are now above $60. Maybe this is because we are less reliant on foreign oil, so the fear factor has diminished. Are the markets forward thinking? Crude oil is up 18% from a year ago while the US Energy ETF (exchange traded fund) symbol IYE is down 2%. It's not supposed to work like that.

Finally, it is always interesting to see what is in the Berkshire Hathaway (BRK) annual report, which was released on Saturday. Warren Buffett is considered by most to be one of the greatest investors ever. The letter to shareholders doesn't seem to have the usual wit it usually carries. Maybe he is finally starting to slow down. BRK currently has $125 billion in cash, and $350 billion in shareholders equity. That is 36% of their net worth in cash. He is obviously waiting for an opportunity. In the pension liabilities section, the BRK pension is underfunded by 10%. Seems a little odd, but more importantly, the future return expectation for the pension is 6.4%. This could be a window into his crystal ball.

In Saturday's *Wall Street Journal,* The Intelligent Investor article had the following excerpt: No formula, however, can subtract all surprises from the future. "There's only so much uncertainty any valuation measure can control," says Prof. Deringer, himself a former financial analyst. "You're always left with imprecise, qualitative assessments of something, and it's often the very thing that makes all the difference." One reason stocks tend to have high returns over the long term is to compensate investors for the risk of losing 50% or more in the short term. Another is that there never has been, and probably never will be, a foolproof way of telling exactly when that risk might materialize.

So goes February.