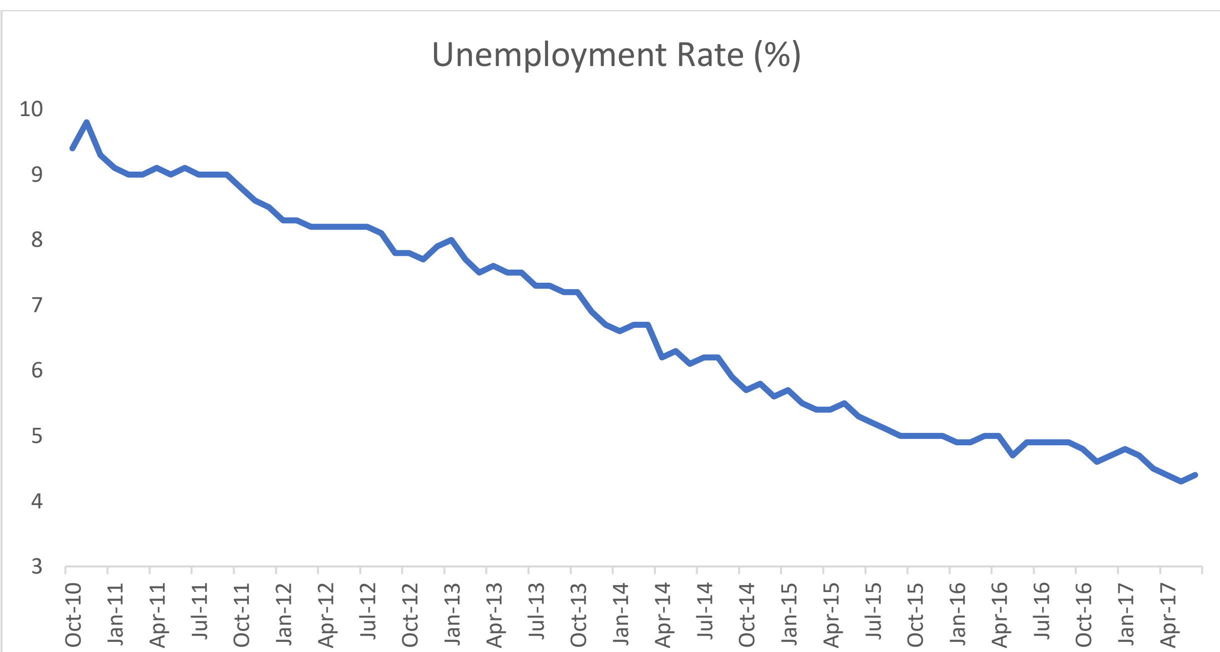
Second Quarter 2017 Commentary

The stock market continued its ascent during the second quarter, with all major stock indexes experiencing multiple record highs during the three-month period. For the quarter the S&P 500 produced a total return of 3.1%, while the Dow Jones Industrial Average returned 4.0%.

Since the presidential election last November 8, the broad U.S. stock market averages have exhibited outright enthusiasm, advancing about 15% since then. Our President seems delighted with the news, having tweeted about the stock market several times so far this year. Most recently he tweeted on July 3 that the "Dow hit a new intraday all-time high!"

President Trump has also enjoyed tweeting about the strength of the American economy since he took office. For instance, on June 11 he tweeted about the "great economic news" that the unemployment rate was "down to 4.3%." We were surprised by this message, because our President had been distrustful of the Bureau of Labor Statistics' (BLS) calculation in the recent past, calling it a "phony number" and at one time saying the reported unemployment rate is one of the "biggest hoaxes in modern politics."

The fact of the matter is that the Bureau of Labor Statistics is not a political body, and its calculations and methodology are the same in 2017 as they were in 2016, in 2015, and for many years before. So we hope that you will ignore the bluster coming from Washington about the numbers themselves, and just relish the fact that the state of the American workforce has been steadily improving, as shown in this chart:

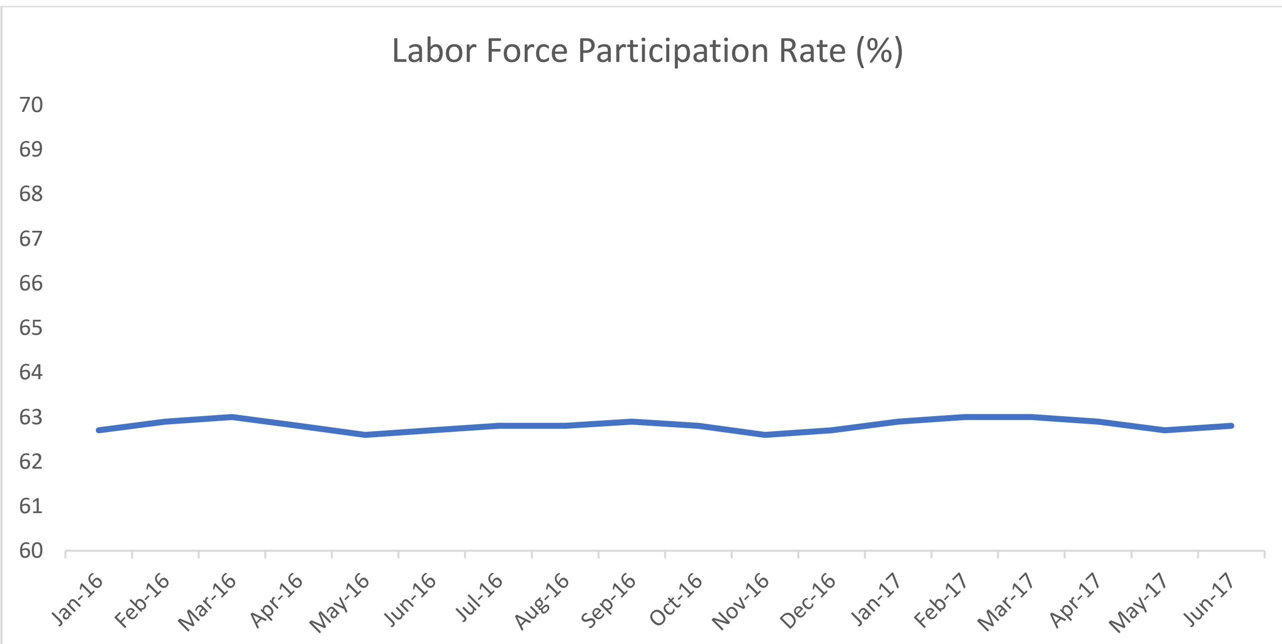


Source: Bureau of Labor Statistics

A Phony Critique

One common erstwhile critique of the BLS' unemployment figure was that it did not take into account something called the "labor participation rate." This is a figure, expressed in percentage terms, of the amount of the civilian working age population above the age of 16 who is either working or actively looking for work. That figure currently stands at about 63%, meaning that about two-thirds of Americans are in the work force, and a little over a third of us are not. Those who are not are predominantly college students and retired folks.

While the labor participation rate had been coming down for several years after the 2008-09 financial crisis, fueling some of those "phony" tweets we looked at earlier, much of that was due to a coincidence of the Baby Boomer generation entering its retirement years. Over the last year and a half, the figure has barely budged: it stood at 62.7% in January 2016, 62.9% in January 2017, and 62.8% in June 2017.



Source: Bureau of Labor Statistics

Tech Love

The recent market optimism has been most evident in the technology sector. In fact, the five largest companies in the U.S. by market capitalization are currently all tech companies. At one point in June, these five companies accounted for about 40% of the S&P 500's return for the year. Think about that for a second: just five companies accounted for nearly half the return of an index comprised of 500 companies.

To further put it in perspective, it is instructive to compare the *increase* in market capitalization of these five companies to the *entire* market value of some well-known companies.

Company	Approx. Increase in Market Value in First Half of 17
Apple	$215 billion
Alphabet (Google)	150 billion
Amazon	130 billion
Facebook	120 billion
Microsoft	85 billion
Total	**$700 billion**

Company	Approx. Market Value at 7/11/17
Boeing	$125 billion
Nike	97 billion
UPS	95 billion
Starbucks	83 billion
CVS Health	79 billion
Time Warner	77 billion
Costco Wholesale	65 billion
Caterpillar	64 billion
Colgate-Palmolive	64 billion
MetLife	60 billion
FedEx	58 billion
Monsanto	51 billion
Kimberly Clark	45 billion
Delta Airlines	40 billion
Kellogg	23 billion

Source: Yahoo! Finance. Increase in Market Value is calculated based on the difference between the highest share price reached so far in 2017 and the closing price at 12/31/16.

These five tech giants grew their market value by an aggregate $700 billion in the first half of 2017. Since its founding in 1916, The Boeing Company has grown to a *total* market value today of about $125 billion. Which means the five tech giants have grown in just six months more than five and a half times the size that Boeing has grown in over 100 years.

Oftentimes, investors forget that when they buy a stock they are actually buying an ownership stake in a business. They forget that the price of a stock is not a random number in a stock chart, but that it corresponds to the actual value of a company. When you realize that in the space of six months the value of Apple *increased* by more than the entire gross domestic product (GDP) of many countries and by more than the entire value of many well-known companies one has to, at the very least, pause for a moment and think. Is Apple really worth one Portugal more than it was worth half a year ago?

Conclusion

The discussion above bears the question: if the economy seems to be chugging along on a similar trajectory to the one it was on before the 2016 election, then why is the stock market so much more optimistic now? That is a question that has no easy answer, and in times like these we remind ourselves of Benjamin Graham's allegory of Mr. Market. We should think of the market as an emotional fellow that at times feels depressed and offers us to buy his stocks at bargain levels, while at other times he feels euphoric and refuses to sell his stocks at any but the highest of prices. It seems to us that lately Mr. Market has been feeling much more euphoric than depressed.

Some stock market pundits try to explain the current atmosphere by pointing to things like rising consumer confidence and potential tax reform as reasons why the market is deservedly higher. They might be right. Or, they might not. But we're not going to play that game; we will not justify paying high prices in the *hope* that something or other might happen. We will continue to do what we always strive to do, which is not to chase the next hot stock, but try to discover value where we can find it. And when the inevitable downturn in the market happens, we hope to be ready to grab some good companies trading at fair prices.

Thank you once again for your confidence, support, and referrals. We look forward to reporting to you again in three months.

Sincerely,

FELIPE

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