

# the Connection

A Quarterly Review

2nd Quarter 2016

## Where Do We Go From Here

Through the midway point this year, a lot has happened. The worst start to the U.S. stock market ever, continued political fracturing globally, **BREXIT**, Chinese debt problems, Interest rates lower than anyone has ever seen, and potential stagflation or deflation, or any number of other reasons why the world is in terrible shape. We will go through the Pros and Cons again, and attempt to explain why the U.S. market continues to shrug off bad news.

The negatives are there. We all know them, here in the U.S. and globally. How is China going to grow out of its increasing debt burden? Where will the next mega growth arena be, now that China is part of the modern global economy? What does **BREXIT** mean for the global economy? Are we going to continue to have a global economy? What happened to the middle class? Where is wage growth going to come from? How are we going to address the lack of skilled labor in the U.S.? Has the economy switched from “what you do” to “what you know”? Social Security, Medi-Care, Pensions, unfunded general obligations, Puerto Rico, taxes, North Korea, Lofty Stock valuations... The list seems endless.

With all that being said, there are a few things we like about this market and the global economy. Wage demand is coming back, even in unskilled labor. This is cheating a little bit, but Starbucks just announced (7/11/16) a 5% raise for all of their baristas (that is a lot of people). Couple that with Wal-Mart's \$15 an hour by 2020, and several other initiatives like it, and you get a lot of people with significant pay increases over time. Minimum wage may not be increased, but when the single largest employer in the United States increases their wage significantly above minimum, they may have just created the new minimum wage.

Education reform may make higher learning more accessible. Whether it should be or not is another question, but the general idea is that Americans need better options for careers, instead of lower end jobs. The good news is that we all see it; so it is a big push by both parties in politics. These potential new careers are going to be very important with an ageing population that relies on younger people to support them through taxes and pensions.

Valuations are on the high end, most investors know this. But compared with where 5 and 10 year treasuries are, they don't look so damning. Investing is much like macro physics, its relative. So if our five year treasury gets us \$1 per \$100 invested, and the S&P 500 gets us \$2.50 in dividends per \$100 invested, the stock market doesn't look too bad. Combine that with tax treatment, the \$1.00 from the treasury gets taxed as income, and the \$2.50 in dividends gets taxed as Long Term Capital gains lofty stock valuations start to make sense.

Mergers and Acquisitions are another positive that we see over the next 12-18 months. U.S. corporate tax being extra-ordinarily high actually helps the M&A world, in a backwards way. Public companies are sitting on a lot of cash, and a lot of that cash is sitting somewhere outside the U.S. To bring that cash back to the U.S. costs about 30 cents on the dollar (and everybody wonders why they leave it overseas?!?). So if you are a big tech company, with billions of dollars, there are a few available options. You can buy a company. You can change your capital structure. You can borrow money you don't need to borrow. Or you can do all three. The details can be complicated, and parts of the U.S. government are trying to figure out how to stop it, but suffice to say, there will be numerous companies that get bought here in the U.S., either by domestic competitors, private equity funds, or foreign competitors looking for entry points into the U.S.

## The Act of Giving

Below is an updated list of some organizations our clients are helping today. Please let Barbara know the names of organizations you care about and we will include them on the list next quarter. Send email to [bcorley@gencappm.com](mailto:bcorley@gencappm.com)

### *All Local Food Banks*

[www.sfmfoodbank.org](http://www.sfmfoodbank.org)

[www.shfb.org](http://www.shfb.org)

[www.foodbankccs.org](http://www.foodbankccs.org)

### *Image for Success*

[www.imageforsuccess.org](http://www.imageforsuccess.org)

### *Maya's Music Therapy*

[www.mayasmusic.org](http://www.mayasmusic.org)

### *Canal Alliance*

[www.canalalliance.org](http://www.canalalliance.org)

### *Friends of the Urban Forest*

[www.fuf.net](http://www.fuf.net)

### *Guide Dogs for the Blind*

[www.guidedogs.com](http://www.guidedogs.com)

### *Doctors without Borders*

[www.doctorswithoutborders.org](http://www.doctorswithoutborders.org)

### *The Nature Conservancy*

[www.nature.org](http://www.nature.org)

### *National Kidney Foundation*

[www.kidney.org](http://www.kidney.org)

### *Guide Dogs of America*

[www.guidedogsofamerica.com](http://www.guidedogsofamerica.com)

### *Golden Gate National Parks Conservancy*

[www.parkconservancy.org](http://www.parkconservancy.org)

### *Fine Arts Museums of San Francisco*

[www.famsf.org](http://www.famsf.org)

### *Canine Companions for Independence*

[www.cci.org](http://www.cci.org)

### *Alzheimer's Association*

[www.alz.org](http://www.alz.org)

### *The Foundation for Rotary International*

[www.therotaryfoundation.org](http://www.therotaryfoundation.org)

The Consumer looks pretty good, which is another bit of positive news. Consumer spending is the largest factor of economic growth in the U.S. and drives growth in other areas of the globe as well. Our dollar is strong, and although that may create reduced returns for U.S. corporations selling overseas it does allow us to purchase more from weaker economies around the world which is good for them. The growth may not come from China, it may come from our wallets; driving the growth in untapped areas. We see exciting things in middle Africa, the Philippines, Indonesia, India and several other countries that have larger populations, and modernization potential. U.S. consumerism will help push that along. This gets into what we look for in companies. Earnings can be manufactured, legally and illegally. Bottom lines are really a tax item, not a true cash return for most companies (and for most wealthy individuals). The hardest thing to fake is sales growth. We look for companies that find ways to protect their sales, increase their market share, and sell more. We believe that earnings will take care of itself.

We don't know where the market will go tomorrow, or next week, or next year. We have been cautious since we founded Gencap, and we were cautious before that. As a client, and an investor, keep in mind something that Stephen Bradley Sr. has said to us many times over the last two decades. Good times go by unnoticed, and very quickly, and bad times seems to last forever. But everything passes, and the market moves inexorably onwards, and generally upwards.