TUFTON CAPITAL MANAGEMENT

Viewpoint

SPRING 2017

In a market that can be difficult to anticipate, there's a simple pleasure to seeing spring arrive right on time. And if the April showers outside our office are any indication, it would seem that May is planning to make a colorful entrance, indeed.

Of course, encouraging though the view outside our windows may be, rest assured that your team of investment professionals remains focused on an entirely different landscape. In the first three months of 2017, as the Fed raised rates and forecasters fretted over policy, the S&P 500 rose by roughly 6%, while the Dow Jones Industrial Average rose by nearly 5%. Together, these indices contributed to the best quarter for American equities in over a year, and the best quarter for global equities in over three years.

To some, these gains signal clear skies—and good times—ahead. In a recent poll survey of C-suite sentiment, JP Morgan Chase found that over three quarters of executives expect the new administration to be a boon for business. On Wall Street, where marquee brands like Canada Goose and Snapchat are stepping out confidently into the public markets, the feeling appears to be mutual. As Goldman Sachs chief Lloyd Blankfein pithily put it in a February presentation to clients, "It feels like...it's going to get growthier."

But as the bull market officially enters its ninth year, some participants are less inclined to believe that hope and growth spring eternal. Nor are their fears without warrant. Casting aside the financial media's more frivolous concerns (the President's "tweets," it is now clear, are not world ending), the case for treading thoughtfully in the days ahead remains strong. Given the historically low levels of volatility that attended to this quarter's growth, we believe that large swaths of investment capital remain stuck on the sidelines, still waiting for the dust to settle around American policy. And as both physicists and economists will attest, the more pent-up energy a system contains, the more cause to handle it with care.

Which is, I'm pleased to report, precisely how your Tufton Capital advisors are handling the trust you have placed in us: with the utmost of care. Since 1995, our firm has favored principled investing over economic forecasting, with the intent of protecting and growing client capital regardless of broader market conditions. Historically, we believe this "all-weather" approach has kept our clients in good stead. As the May flowers begin to bloom, in this period of prolonged uncertainty, our approach will remain the same.

In the pages ahead, you'll find a brief overview of our current market thoughts, including select investments we continue to believe offer meaningful long-term opportunity. Should you wish to discuss these or any other matters related to your portfolio, we sincerely hope you will pick up the phone and give us a call. We remain at your service and look forward to providing you, our valued client, with the level of attention, insight, and performance you have come to expect—no matter what comes next around the bend. ■

Chad Meyer, CFA
President

Inside This Issue

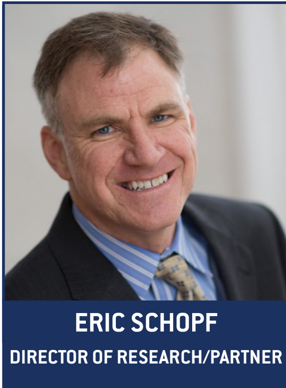
The First Quarter Of 2017: March Madness — Page 2

How Hot Is Too Hot? — Page 4

Company Spotlight: ExxonMobil (Ticker: XOM) — Page 5

Giving Options For Wealthy Donors — Page 6

The First Quarter Of 2017: March Madness



ERIC SCHOPF
DIRECTOR OF RESEARCH/PARTNER

The stock market built on year-end momentum and racked up impressive gains in the first quarter. The Standard and Poor's 500 provided a total return of 6.07%. Optimism ran high for President Trump's aggressive fiscal policy. Consumer confidence reached levels not experienced since 2000. The mantra of lower taxes, reduced regulation, and increased infrastructure spending was the sweetener for a powerful sugar buzz. The market's rapid ascension was dubbed the "Trump Bump."

The sugar high began to wear off as plans to repeal and replace the Affordable Care Act floundered. Even with control of the House and Senate, Republicans could not find common ground. Revised healthcare legislation didn't even make it to the Floor for a vote. With that failure, suddenly the remaining tenets of the President's platform appeared vulnerable. The Trump Bump became the Trump Slump as the stock market delivered negative returns in March.

The President continues to dominate the news cycle. Unfortunately, his polarizing temperament and rhetoric have somewhat obscured the economic fundamentals. Looking instead at the economic data, all the forward-looking indicators are solid. Payroll growth and manufacturing activity have been robust. Additionally, new manufacturing orders and production are at two-year highs. Although manufacturing represents a small portion of the U.S. economy, it serves as an important bellwether.

The bond market paints a similar picture as the stock market. Through mid-March, interest rates across the yield curve moved higher in anticipation of better economic growth combined with higher inflation. Then, failure to enact healthcare reform resulted in intermediate and long-term interest rates falling precipitously. After this fall, yields on U.S. Treasury securities with maturities greater than two years are lower than at the start of the year. Interest rates on Treasury securities inside of two years are higher than at the start of the year, because the Federal Reserve has continued to lay the groundwork for additional interest rate increases through the balance of the year.

Of course, this wouldn't be a financial newsletter without mention of the Federal Reserve. The positive economic impact of the Fed's accommodative monetary policy following the Great Recession cannot be overemphasized. Over the past five years, the Fed has walked back potential interest rate increases many times. Going forward, the success or failure of the Trump administration's monetary policy will play a key role in Fed policy. Should economic growth fail to launch, there is little reason to be aggressive with rates. A continuation of low interest rates can keep the slow-motion recovery moving forward.

In addition to monitoring the Fed's policy regarding short-term interest rates, we are also monitoring its management of the $4.5 trillion fixed income portfolio amassed as part of their quantitative easing program. These U.S. Treasury and mortgage-backed security purchases were made to push interest rates lower across the yield curve. Eventually, steps will be taken to wind down the financial operation by allowing bonds to mature without reinvesting the proceeds. Allowing bonds to mature in this way is in effect a drop in demand for the securities and should result in higher interest rates.

The stock market weakness in March did not come as a great surprise. There is an old saying on Wall Street, "buy on the rumor and sell on the news." The President was swept into office with a clear message and was warmly embraced by the stock market. During this period of "rumor-buying," the S&P 500 provided a total return of nearly 16% between election day and the intra-quarter high set on March 1st. The reality of the gridlock in Washington is the not-so breaking news that tempered investor enthusiasm. As

we mentioned in the fourth quarter newsletter, the market posted very strong gains in anticipation of "making America great again." We could see further consolidation over the coming months as the task is put to the test.

The risks going forward are similar to those confronted over the past year: monetary policy initiatives with a leveling dose of fiscal policy to keep the economy on an even keel. Trade policies are a work in progress, and Europe shows the stress of being pulled in many different directions. As always, we remain vigilant in managing your portfolio to balance risk and reward.

In closing, Tufton Capital would like to make a brief comment on the political environment. This newsletter has never been political in nature, and we are not starting now. Nevertheless, we cannot ignore policy actions by our executive, legislative and judicial branches of government. Words, such as "polarizing" and "warmly embraced," are selected with great thought. We realize that our clients span the political spectrum, and some may not agree with our characterizations. The post-inauguration period has created a level of consternation that we haven't seen in a long time. Let us assure you that we remain focused on the fundamental attributes of the companies we own and the underlying economy. In turn, it is important for you to remain focused on your long-term investment objectives and the investment policies that have been put in place by us to help you meet your goals. Sharp deviations from a sound investment policy could be very costly. ■

Source: FactSet

How Hot Is Too Hot?

JOHN KERNAN
RESEARCH ANALYST

Many of our clients have been asking questions about the (real or imagined) "peaking" of the market. They have seen one of the longest continuous bull markets in history and are telling themselves that the party must end sometime. One of the more confusing pieces of this puzzle is the role of the Federal Reserve and its interest rate policy. The Fed plays a delicate game with interest rates. It seems like the markets live or die by the Fed's moves, and what the Fed does with rates has real consequences for all kinds of investors and businesses.

What is the "game," exactly? What makes an interest rate "too low"? Wouldn't we want the economy to grow as much as possible, all the time?

It comes back (as it always does) to the laws of supply and demand. If the economy is doing well, people are feeling good, and businesses are selling their products, it creates a self-reinforcing cycle. More products being sold leads to managers increasing their purchases of equipment, hiring new workers, and extending workers' shifts. These workers then have more money, start spending more, and so on.

Then, when the cycle eventually turns downward, businesses are left hanging with too many employees, too much equipment, and too much inventory, which results in lower prices, which decreases business income, which results in more layoffs, which means less consumer spending…

The debate comes in when we try to pin down what is causing these fluctuations. Classical economists argue that the causes are mostly **exogenous**, a result of factors beyond the reach of the markets or their policies, such as a war or a major technological change. Underconsumptionist (or Keynesian) economists argue that **endogenous** factors cause recessions, with private firms making decisions that lead to inefficient allocations. These decisions must then, they say, be corrected with policy changes[1].

Let's compare these theories with what the Fed actually does. The Fed's buying or selling of bonds increases or decreases money available in the banking system. Doing so is an attempt to curb the effects of the business cycle on both ends. Preventing the economy from getting "too hot" means discouraging businesses from overinvesting when times are good by increasing the costs of borrowing to finance those purchases. Stimulating a lagging economy is accomplished by making more money available to businesses for investment, hence the term "easy money."

These policies sound great in theory, but there are plenty of people who disagree. The aforementioned economists who believe in exogenous (external) causes to market cycles argue that tinkering with interest rates only *increases* the inefficient allocation of resources. The division is not absolute, and many economists who believe in exogenous factors still argue for some degree of governmental involvement, and vice versa.

We've now painted a brief picture of the dizzying field of modern economics. Throw in political pressures, and the Fed has quite a task on its hands. The mandate given by Congress is for the Fed to maximize employment, stabilize prices, and moderate long-term interest rates.

There are many, many factors that the Federal Open Market Committee at the Fed considers when making a decision regarding interest rates. Since inflation is straightforwardly set by monetary policy, it would seem to be simple for the Fed to buy or sell bonds to increase or decrease the money supply, thereby increasing or decreasing inflation.

(Continued on page 8.)

1 There are many other ways to explain booms and busts. A few examples are the Austrian, Real Business Cycle, and Marxist economic theories, as well as pointing to the credit/debit cycle or to politics.

Company Spotlight: ExxonMobil (Ticker: XOM)

TED HART
RESEARCH ANALYST

Started by John D. Rockefeller as Standard Oil in 1870, ExxonMobil (Ticker: XOM) is the world's largest diversified petrochemical company with a market capitalization of $343 billion. The company is split into three businesses: Upstream, Downstream, and Chemical. The Upstream segment engages in the exploration and production of crude oil and natural gas. Downstream refines the oil into liquids such as gasoline and markets the finished product at your nearby gas station. Finally, the Chemical business manufactures chemicals like ethylene, which is a basic petrochemical product that is the building block for many everyday products including packaging materials, storage containers, bottles, and toys.

Over the past decade, the company has had trouble growing production as new exploration has failed to move the production needle. Because the company wrote down higher cost reserves and lower oil prices continue to weigh on earnings, the stock is currently off 20% from its all-time high. However, earlier this year ExxonMobil made a significant shale acquisition in Texas' Permian Basin that could contribute up to 350,000 barrels per day of production. The company paid about $27,000 per acre and $1.60 for each potential future barrel of oil – remarkably cheap compared to other transactions. The acquisition could increase the company's production by up to 8% over the next few years.

On top of the new stellar production profile, the company is due to increase its dividend. If ExxonMobil increases the payout by 5% (slightly more than the mere 3% last year), the stock could yield 3.8%, while the S&P 500 is yielding 2%. Additionally, for those investors worried about an overvalued stock market or uncertain fiscal policy, ExxonMobil has outperformed in four of the past five bear markets by an average of 16%.

Oil prices cannot remain at these levels over the long term. Many exploration and production companies are currently not profitable. Almost as importantly, most oil service companies that help the producers get their wells up and running are financially stressed. As the Federal Reserve continues its path to raise interest rates, these companies will have difficulty renewing their revolving credit lines. Restructurings and bankruptcies will likely occur, leading oil supply to decline. With oil demand growing about 0.7% per year, oil supply coming offline should result in higher prices. With a pristine balance sheet, ExxonMobil should be there to benefit. ■

ExxonMobil (Ticker: XOM) Stock Chart

Source: FactSet

Giving Options For Wealthy Donors

As a wealthy donor, the options available for charitable giving multiply.

You can have more control over how your donations will be spent, even potentially directing how each charitable dollar is allocated. While some of these options may require more planning and administrative work than direct giving, they also provide the potential for a deeper charitable impact and the chance to leave behind an enduring charitable legacy. Before deciding to use one of the following options in your charitable giving strategy, take time to learn about the obligations and resources each will require as well as the potential tax benefits each can offer.

Private foundations

Both private foundations and public charities have the same overall mission. They serve a particular public interest or they enhance the common good. However, while public charities are funded by the general public, private foundations depend on a principal fund that is generally backed by a single source, such as an individual, family, or corporation. This specialized source of funding means that private foundations can be much more selective about the causes they support. Since they don't need to appeal to the public to remain funded, private foundations allow donors to truly focus on the causes they believe in most.

Beyond simply donating money, starting a private foundation also requires a significant amount of time. Foundations are managed by a board, which can include family members, friends and financial advisors, who defines charitable goals and manage donations. This board is responsible for investing and managing the principal fund and using it to make grants to individuals or public charities for charitable activities. By investing charitable dollars, you have the opportunity to enlarge your charitable donations, which can allow individuals or families to give more than initially planned. Unlike other investments, a private foundation's investments are only taxed at a rate of 1–2 percent, allowing your investments to grow faster inside a private foundation than outside. Private foundations, as a unique form of charity, have specific restrictions according to the IRS. They must distribute at least 5 percent of the fair market value of their assets each year to qualifying charitable organizations. Donations to private foundations are also deductible at a lower rate than donations to public charities—30 percent of a donor's adjusted gross income for cash gifts and 20 percent for capital gain property. It's important to note that private foundations are watched closely by the IRS for misconduct and can have complicated tax restrictions when it comes to the relationship between board members and the foundation. You should be sure to consult with legal and tax professionals before and during the planning process.

If you or your family decides that a private foundation is the right fit for your charitable strategy, it's important to make sure you have sufficient initial funding to cover the administrative costs as well as the time to devote to serving on the board. If you believe you and your family can contribute these resources, choosing a private foundation for your charitable strategy can provide you with a built-in way to pass on your charitable values by developing an intergenerational board of family members. For individuals or families who have specific charitable interests and a large pool of resources, private foundations can also be an opportunity to make a true impact on a personal cause.

Private operating foundations

While private foundations offer the opportunity to direct funds to specific charitable activities, that's not all they can do. Private foundations fall into two different categories, depending on how they function: operating and non-operating. The type of private foundation discussed in the previous section is non-operating. Rather than carry out their own charitable activities, this type of foundation seeks to raise funds and provide money for other established charities. Private operating foundations, on the other hand, use the bulk of the money they receive from donors to run their own charitable programs or services. For example, two common types of private operating foundations are museums and libraries.

Although private operating foundations may choose to donate to other charities in addition to their other charitable activities, they must actively run their own programs to qualify as a private operating foundation with the IRS. The IRS also has strict qualification requirements regarding private operating foundations' net income and assets, which should be researched thoroughly and discussed with a legal and financial advisor before making any final decisions.

Private operating foundations will likely take time and resources beyond those of a private non-operating foundation, since you will have to plan and allocate resources toward charitable activities on your own. However, private operating foundations provide an additional opportunity to become involved in your community and to directly interact with the people or cause you want to serve. The extra effort can also pay off in terms of tax benefits. Private operating foundations are eligible for the same tax deductions as public charities (50 percent for cash donations and 30 percent for capital gain property). Private operating foundations appeal to many families because this unique structure is a hybrid of public charities and private foundations.

Donor-advised funds (DAFs)

Donor-advised fund, similar to private foundations, are designed to allow you to grow your donation to charity through investment. However, DAFs offer less time commitment than private foundations, which can be especially appealing if you don't have time to serve on a board.

Donor-advised funds are administered by a sponsoring organization, so donors also avoid the burdens of fund management and administration. Although these sponsors charge fees for the creation and management of DAFs, the investment returns they produce help to build the value of the fund and to generate more money for charity than a simple gift. The flip side of this added convenience is that donor-advised funds, as the name implies, are only subject to a donor's advisements. Although most sponsoring organizations will do what they can to follow the donor's wishes, they do not have a legal obligation to do so. Therefore, putting your money into a donor-advised fund rather than a private foundation does somewhat limit your control over these funds.

DAF donations are subject to the same deductions as donations made to public charities and offer the full 50 percent income tax deduction for donors. In addition, money within a donor-advised fund can grow tax free and has no minimum distribution requirements. Unlike private foundations, which make it hard to give anonymously due to the tax reporting required, donor-advised funds make it possible to retain donor anonymity, because donations can be made in the name of the fund rather than the individual.

Donor-advised funds may be a good choice for your charitable giving strategy if you feel strongly about making a large charitable impact, but don't have the time to commit to a private foundation. If you are starting on your charitable strategy later in life, donor-advised funds may also be more appealing because they allow you to start your donations right away and avoid the start-up period of a private foundation. DAFs also easily allow for a wide variety of charitable interests. Private foundations generally have a focus (although they may not be legally bound to give inside that focus), but DAFs allow you to share your wealth in a variety of ways by dividing your fund's assets and giving them to multiple sources. However, depending on the donor-advised fund you choose, DAFs may limit your opportunity for intergenerational giving, since some have restrictions on successions. Consulting a legal and financial professional before choosing a DAF can help you determine which DAF is best for you, including helping you find those that offer the opportunity for intergenerational succession.

If your family is able to donate a large amount of wealth to charity, you may want to consider one of these extended options for charitable giving. Each provides a way to potentially involve multiple generations of your family in your giving activities, uniting your family behind your charitable vision and strategy. ■

(How Hot Is Too Hot... Continued from page 4.)

But in practice, much of the reality of inflation is out of the Fed's hands, or is inversely linked to employment. What would lower inflation would raise unemployment, and vice versa. Inflation depends not just on the *existence* of more money, but also on its *velocity*, or how quickly it is being spent. Since the financial crisis, large financial institutions have been very slow to spend money, resulting in a low velocity of money. If firms suddenly had a shift in preferences and began spending that money (again, which would be largely outside the Fed's purview), inflation would rise, and the Fed would need to increase its purchases of bonds to keep it under control, potentially interfering with its other policy goals. So, how hot is too hot, when it comes to interest rates? Unfortunately, the answer is highly dependent on how the Fed views the current state of the economy. It depends.

Expectations about what the Fed will do also significantly affect the economy, so an important part of its policy implementation is how it communicates with the public. The Fed conducts and publishes many research initiatives to communicate to the public its expectations for the economy. This allows businesses to better plan for the future and gives decision makers more confidence in their choices.

Coming back to the question at hand. How hot is too hot? If one of the goals is maximum employment, what is the Fed's unemployment target? Of course, it can't be zero. There is a natural rate of turnover when people are between jobs. This is confounded by the recent phenomenon of labor force drop outs. What is the "natural" rate of labor force participation? The maximum employment rate is, in fact, a moving and elusive target. The Fed must decide on a level that is right for any given environment. How hot is too hot for unemployment? It depends.

The third mandate, stable interest rates, means that the Fed must also have some foresight into what the short and medium-term effects of its actions will be. If interest rates are to remain steady, the Fed cannot put itself in a position where it must react to sudden swings in employment or inflation. Otherwise, corrective action by the Fed would mean highly volatile interest rates. How hot is too hot? It depends. ■

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