

CAZ Investments

Quarterly Letter

Could the Tide be Turning?

The 2nd quarter was a continuation of the same trends that we have seen since the election. Very little progress on the legislative front, reasonable corporate earnings, a stable job market, lots of saber rattling out of North Korea and, of course, slightly higher stock prices... However, as we sit to write this, the world is beginning to feel a bit different. The President and the regime in North Korea are embattled in a war of words and steps are being taken in South Korea, Japan and Guam to prepare for a potential irrational act. We are prayerful that no such act occurs but the market has correctly woken up to the economic risks created by uncertainty and provided a glimpse of what a downside move could feel like, if it begins to materialize. As we enter the fall, a seasonally problematic time for markets, we maintain a very cautious outlook and encourage investors to maintain the minimum amount of stock exposure that they are comfortable with. We remain a “1” on the CAZ Scale because valuations are excessive, as they appear to have priced in more potential good news than we believe is likely warranted.

Economic growth remains tepid and the markets appear to be growing anxious as to whether politicians in Washington D.C. will be able to take action on the four areas we discussed last quarter:

1. Regulatory reform
2. Health care reform
3. Tax reform
4. Infrastructure spending

An Update on Potential Growth Drivers

So far, the progress has been quite unenthusiastic. For those that like gridlock and less action by government, they have gotten their wish, as very little has happened other than posturing, failed votes, political bickering and finger pointing. Based on our research and feedback from relationships that are deeply involved in the political process, here is what we believe today about each of these areas.

1. Regulatory reform – There is slow progress in this area and some of the early actions are being felt by businesses. This doesn't appear to be driving job growth but it is helpful. We recently saw a statistic from a Barclay's report that was staggering, and we thought it was worthy to share. There is little question that the banking sector is one of the most regulated. The sheer cost of regulatory compliance however shocked us. According to Barclay's, the banking sector's cost of compliance with governmental regulations has skyrocketed by more than 400% in the last six years and now represents **15% of total expenses**. That is shocking and is a clear illustration as to



how excess regulation can hold back job growth and investment. This area does appear to be improving but it is a slow process. We are hopeful that when some of the modifications begin to filter through the system that we will see additional disposable cash flows that can be used to add to economic growth.

2. Health care reform – It is still a mess, and some could argue that it is dead. We are not optimistic that anything significant is going to occur here, but that this area is going to be a continued drag on the economy. We could also be in for some negative surprises as the healthcare exchanges begin to fall.
3. Tax reform – We remain hopeful in this area and believe that a bi-partisan solution is possible. Virtually every constituent can agree on one thing – that the tax code is horribly overcomplicated and needs to be simplified. How things finally shake out is the trillion-dollar question, but we are confident that something will be passed and that could provide a shot in the arm to the economy and investor psychology. However, if the year closes with no health care reform and no tax reform, the markets are likely to be excessively disappointed.
4. Infrastructure spending – We also remain hopeful in this area but grow more skeptical by the day, as it appears that there is little consensus on how money can be directed to major projects without first tackling tax reform, and thereby the direction of the deficit. There simply doesn't appear to be the will, at this point, in Washington to accomplish anything other than stalemate.

The 2018 mid-term elections are clearly in the sights of both parties and the activity over the next 12 months is likely to be driven almost exclusively by polling data and garnering a perceived upper hand. In that environment, it is tough for us to be confident about much being done in Washington and we are afraid that we can't count on legislation to provide a shot in the arm to the economy.

The Fed continues to slowly reduce monetary stimulus, albeit at a slow pace, as they also appear to be concerned that the perceived tick up in economic expansion may not occur as hoped. Long term interest rates have arrested their rise and have become quite stable, at much lower levels than most prognosticators would have expected. The bond market seems to be telling us that a slowdown in growth is potentially more likely than expansion. All of this leads us to believe that we are going to continue to progress forward with modest economic growth, barring a geo-political shock to the system. With that backdrop, we are forced to rely on the most obvious truth available, and that is stock price valuations are expensive on nearly every metric. This market can now claim the title as the 2nd most expensive market in history, bested only by the technology bubble of 1999. As we said then, chasing expensive valuations can be a very costly endeavor, and we choose to not sacrifice our discipline in the name of convenience.

Fortunately for us, as investors in “anything – anywhere,” we don't have to be locked into a particular asset class and will continue to allocate our personal capital to investments that we believe provide outstanding risk/reward characteristics, with a high level of predictability. More often than not, that leads



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us to private market opportunities. Fortunately, as very large investors in that area, we have a consistent and voluminous stream of investment proposals cross our desks. This allows us to be quite selective and see many opportunities most investors simply will not.

Stay tuned for more information from us on how we are gathering those unique situations into investable opportunities for those that co-invest with us. We assume the vast majority of our partners are participating, in some way, in the “great migration” from hot climates to cooler venues. Travel safe and we look forward to seeing each of you very soon.

All our very best,

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