SFS Investment Update

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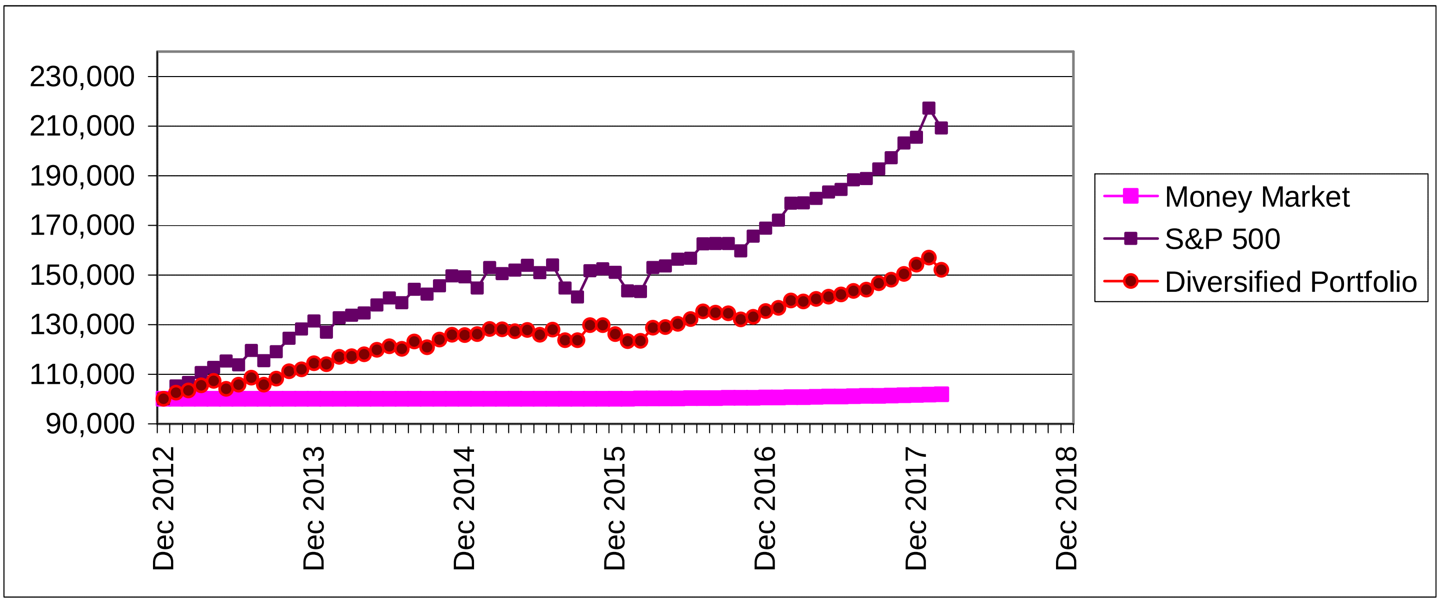
Just When We Thought It Was Safe….

I thought I had this letter all figured out and then things changed. After a terrible first part of February, which we discussed some in the last letter, markets seemed on the way to recovery. The latter part of February continued the volatility that began at the first of the month, but the trend stabilized and actually started to move up. The numbers appeared as follows:



	February	Year-to-Date	Annualized Since 1/1/2013
Diversified Portfolio	**(3.09)**	**(1.27)**	**8.46**
Index Components			
U.S. Stocks	(3.71)	1.39	16.05
International Stocks	(5.13)	0.16	7.19
Bonds	(1.02)	(2.10)	1.51
Real Estate	(7.64)	(11.53)	6.73
Money Market	0.11	0.23	0.39
S&P 500	**(3.68)**	**1.81**	**15.36**
Money Market	**0.11**	**0.23**	**0.39**

Even with losses in all asst groups except the money market, the diversified portfolio bested the general market and the S&P 500, losing 3.09 percent compared to 3.71 and 3.68 percent respectively. Bonds were again battered, down 1.02 percent and real estate gave up 7.64 percent. The latter was also hurt by questions of how the new tax law may impact some REITs; we continue to watch this issue and for now believe the problem is overstated.

Then comes March 1 and the President announces his intention to levy a 25 percent tariff on steel and a 10 percent tariff on aluminum. And, the Dow plunges 645 points as the majority of investors, economists and Republicans immediately pan the idea. So what happens next?

If the economic consensus is correct, then not much good comes from the decision. Since the tariff wars of the early 1930's, traditional economics has held that tariffs serve to reduce trade between countries, offer some limited assistance to the industries immediately impacted (in this case, U.S. based aluminum and steel producers), cause job losses in secondary industries (automobiles and soup cans) and over the longer-term serve to reduce economic growth. They are seen as an unnecessary economic barrier imposed by government, or to quote Larry Kudlow (analyst on CNBC) a stealth tax increase.

The impact is not immediate, and oftentimes unexpected. For example, an analyst said that one of the major losers from the decision was ExxonMobile and other energy firms. The rationale is that as U.S. oil production continues to grow and help firms like Exxon, the industry needs pipelines to move oil to refineries. The price of steel goes up, the firms that build and own the pipelines like Kinder Morgan have to pay more to build the lines and they pass that cost on to Exxon. In turn, either Exxon "eats" the increase and reduces profits or passes it on to consumers, who see an increase in the price of gasoline at the pump.

It is my belief that in general tariffs do more harm than good. The only winners are industries that receive the protection, and most everyone else losses in some fashion. Politically, they create ill-will among allies: witness the outcry from Canada who is one of our major steel producers. They generate uncertainty for business, which is not conducive to growth. Lastly, they can be an important ingredient to inflation and increases in interest rates.

The real test here for investors, despite how the market reacted on Thursday, is not the first round but possible retaliation. To go back to the Great Depression, our passage of the Smoot Hawley tariffs in 1930 was problematic even by itself. However, it then generated retaliation from countries worldwide. Thus, if we begin to see other countries impose tariffs on our goods exported to them, then we could see some of the worst case scenarios develop and play out.

Thus, for right now, I advise caution. We need to see if cooler heads in the world's capitals prevail. For example, we could elect to target only certain nations, or reduce the level of the tariffs. The actual orders to implement the tariffs are not complete and will not be ready until later in the week. Other countries may choose to ignore the tariffs, or implement largely symbolic changes. If these actions follow, then we may have much ado about nothing.

However, if the trade "war" escalates, then we will need to reconsider what actions to take against what will be a slow moving threat. The impact from price changes induced by tariffs will not be immediate and thus sudden actions may not be warranted.

In the last letter I stated that absent geopolitical problems or policy mistakes, we were not headed for a recession. Let's hope that this is not one of those "policy mistakes."

As always, we welcome your thoughts and comments.

Roger E. Southward, CFP®