Second Quarter 2017

Quarterly Letter to Clients

By Scott A. Wendt, CFA

July 20, 2017

The fireworks commemorating the celebration of our nation's 241st year of Independence helped close out the 2nd quarter of 2017 in fine fashion. Millions of Americans followed their annual traditions of attending parades, cookouts, and concerts to celebrate the continuation of our nation's grand experiment – forming a new type of government. A government focused not on a king or a ruler, but on the founding principles of a self-determination brought about by a representative democracy. A government memorialized in President Abraham Lincoln's Gettysburg address, as a "… government of the people, by the people, for the people …" A government, which provides the legal foundation for an improvement in the standard of living not seen any other time in human history. While it appears that our nation is undergoing a period of significant social, political and economic change, it is not the first time our nation has experienced such turbulence. Our nation's grand experiment has been tested repeatedly in the past, and most certainly will be challenged again in the future. In spite of it all, the U.S. Economy finished the quarter in much the same fashion as it began. It extended its eight-year growth streak with a mixture of economic indicators that portray an economy that, despite its longevity, continues to expand at a subpar pace.

U.S. Real GDP continues to average near 2%, while demand for goods and services appears to be stymied by a consumer that is optimistic about the future, but not about buying stuff today. A quick survey of recent economic headlines shows that Retail Sales grew a paltry 0.2% for the quarter, on weak household spending. Many U.S. retail chains have announced that they are closing stores across the nation, as it appears more shoppers are buying online and foregoing the trip to the neighborhood mall. With unemployment at 4.4% in June, one would think that the consumer sentiment gauges would continue to improve. However, the University of Michigan recently reported that its consumer sentiment index declined to 93.1 in July, retreating from its June level of 95.1, as consumers start to express some anxiety as to whether or not the expected economic improvements will materialize. The growth of auto sales

continues to decline, with inventories slowly being reduced due to the combination of incentives and diminishing production by manufacturers. Manufacturing output continues to be mixed, with durable goods growing modestly and nondurable goods seeing lukewarm growth. Utility output, a component of industrial production, has fallen over 2% in the past 12 months, while capacity utilization continues to hover around the 76% level, comfortably below the historic 85% level that would be associated with the need to raise prices and impact inflation. This jives with the reported data on U.S. Consumer Prices, which peaked back in February 2017 at just over 2%. Since then, the CPI has been steadily declining to its most recently reported rate of +1.4% on a year-over-year basis.

Overall, the Goldilocks environment continues to muddle along, with expectations about the future really formed around the potential for the Trump administration to reduce taxes and regulations, while giving the Federal Reserve the cover that it needs to continue its path towards a more normal monetary policy. With both inflation and unemployment at low levels, the Fed is now at a point where it can at least *reduce* the level of stimulus. The actions of central bankers around the world have been a primary driver for changes in financial asset prices over the past eight years, so investors and savers should pay attention to the changes announced over the last few months. Central banks in Canada, Europe and the Bank of England have all indicated they either will be raising rates or have begun the process of stimulus reduction.

Bonds & Stocks

Here at home, the Federal Reserve chair has overseen three 25 basis point increases in the Fed Funds rate and recently announced that the Fed's Quantitative Easing (QE) policy, which grossly expanded the Fed's Balance sheet, would begin to be reversed in an "orderly" manner. However, things are likely to get a little more complicated as central bankers jockey to keep their currencies and economies competitive in a world that has never experienced something like the unwinding of the QE program. Money managers around the globe are on alert, realizing that the Central Bankers may remove the proverbial punch bowl while still trying to keep the music going. As Ray Dalio, Chairman of Bridgewater associates wrote recently "Our responsibility now is to keep dancing, but closer to the exit and with a sharper eye on the tea leaves."[1] Bond investors should also heed the warning of JP Morgan CEO Jamie Dimon that rolling back QE may have unknown risks associated with the process because the markets are in uncharted territory. As this attitude becomes more prevalent, markets will most likely react accordingly.

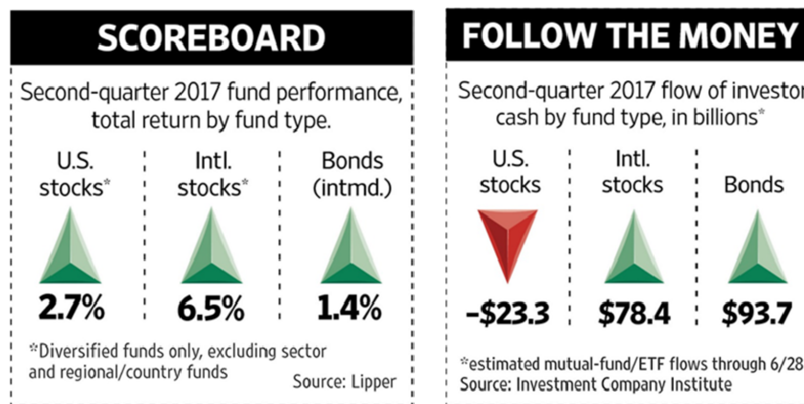
[1] "Ray Dalio's 'keep dancing' advice may raise some bad memories form the last two bubbles" By Tae Kim **CNBC** 7/7/2017.

During the quarter just passed, the bond market saw modest positive improvement, with longer-dated and riskier corporate bonds outperforming short-maturity, high-quality credits. The U.S. Government 10-year Treasury bond ended the 2nd quarter yielding 2.31%, as bond investors bid prices up causing yields to decline from the 2.40% yield marked at the end of the 1st quarter. Continued weak inflation expectations and the lack of progress by Congress to provide any fiscal stimulus most likely contributed to the modest yield decline.

Morningstar Bond Indexes *As of 6-30-2017*

Broad Market	Quarter	1-Year	3-Year	5-Year
US Core Bd TR Bond	1.5	(0.2)	2.7	2.4
US Lng Core Bd TR Bond	3.6	(1.1)	4.7	3.8
US Shrt Core Bd TR Bond	**0.5**	**0.3**	**1.2**	**1.1**
Corporate				
US Corp Bd TR Bond	2.5	2.4	3.6	4.0
US Lng Corp Bd TR Bond	4.0	3.1	4.9	5.3
US Shrt Corp Bd TR Bond	**0.8**	**1.5**	**1.8**	**2.3**
Government				
US Gov Bd TR Bond	1.2	(2.2)	2.0	1.3
US Lng Gov Bd TR Bond	3.0	(5.7)	4.7	2.5
US Shrt Gov Bd TR Bond	**0.3**	**(0.3)**	**0.8**	**0.7**

As we pointed out last quarter, bond investors focus on keeping what they have, while stock investors focus on growth. In the current slow growth economy, investors are paying a large premium over stock values to own those companies with above average growth. The stock market continues to climb higher despite rising interest rates, higher valuations, and the aforementioned reduced liquidity due to the Fed unwinding its balance sheet. Earnings growth is slowing, with the S&P 500 quarterly and year-end EPS estimates repeatedly being revised downward, which puts further upward pressure on already extended valuations. Foreign markets are now providing a reasonable alternative to U.S. Stocks and have attracted a significant level of interest over the past quarter. As the graphic below shows, the average return for mutual /exchange traded funds that invest domestically in U.S. based companies was 2.7% for the quarter, while those mutual fund / ETFs that focused on international stocks rose 6.5%. During the second-quarter 2017, the flow of investments made by fund type showed withdrawals from U.S. Stock funds of $23.3 billion, while significant cash investments were made in bond and international stock funds.



WSJ |Quarterly Analysis |Investing in Funds & ETFs| Sec R1 | July 10, 2017

The Lipper Performance table on the next page displays the range of returns earned by mutual fund managers during both this past quarter and the 1-year, 5-year, and 10-year time periods. For the second quarter of 2017, the table illustrates that larger capitalization stocks performed better than smaller capitalization stocks. In addition, lower quality stocks outperformed their higher quality counterparts. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) increased +3.3%, while the S&P 500 was up +3.0%. The tech-heavy NASDAQ posted a gain of +3.9%. The average mutual fund, represented as General Equity in the table, saw a gain of +2.7% for the quarter. International stock funds appreciated +6.5%.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

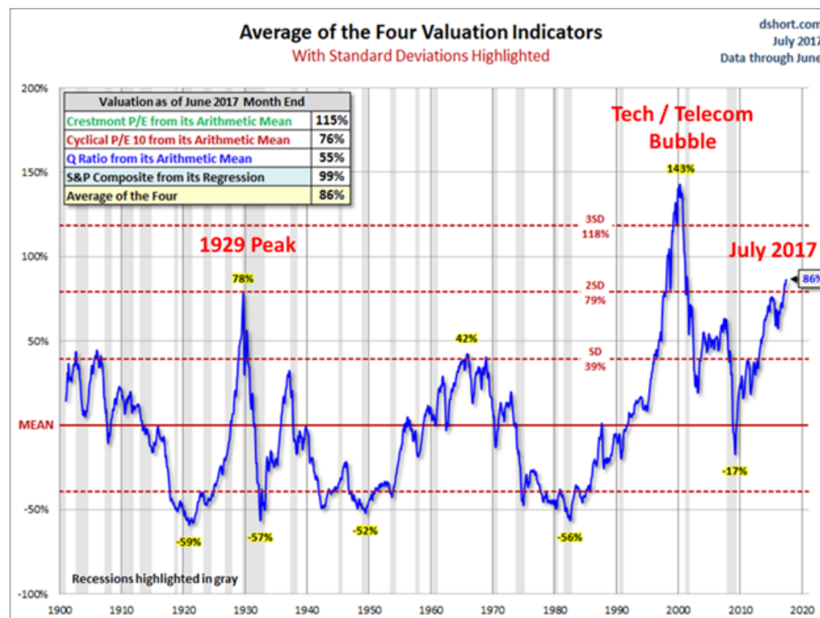
MONDAY, JULY 10, 2017

	Qtr	1 year	5 year	10 year
S&P 500	3.0	17.3	14.0	6.6
S&P 500 Index P	2.6	15.5	12.2	4.9
Dow Jones Ind. Average	3.3	19.1	10.6	4.8
NYSE Composite P	2.3	12.1	8.6	1.8
General Equity	2.7	17.6	12.0	5.7
Multi-Cap Growth	5.0	20.0	13.5	7.2
Large-Cap Growth	5.5	20.4	14.1	7.9
Large-Cap Value	1.9	17.9	12.9	4.8
Mid-Cap Growth	4.8	18.9	12.9	6.9
Mid-Cap Value	1.0	18.0	13.5	6.1

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

What these tables do not portray is the outsized portion of the total returns that have been generated by just a few of the largest stocks in each index. According to a recent Barron's article, "depending on which lovely acronym[2] you use, between 33% to 40% of returns in the S&P 500 are attributable to those sainted stocks alone (and more than 50% of the Nasdaq's returns year-to-date), even though they represent barely 10% of the total market capitalization."[3] This phenomenon has repeated itself numerous times throughout stock market history, with investor's always having to confront the question: Is this sustainable? Historical comparisons would say not. In past periods, like the 1960's and 1990's, when markets were driven by a small number of stocks with high price momentum and valuations that were increasingly disconnected from the company's underlying fundamentals, the reversals were large and generally put the overall market into a downdraft.

The current stock market is expensive by most valuation measures, making it vulnerable to shocks that might change the underlying growth trends of the companies investors own. At the end of the 2nd Quarter, the S&P 500 Median Price / Earnings (P/E) Ratio was 26.0 X, up from last quarter's 24.1 X, significantly above the 50-year median P/E of 17.0 X. Similarly, the Shiller P/E ratio ended the quarter at 30.1X, up from last quarter's 28.9 X, also significantly above the average level of 16.7 X. As the chart below suggests, the average of four prominent stock market valuation measures is now at levels rarely seen over the past 117 years and was only exceeded by the valuations recorded in the famous Technology / Telecom Bubble.



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[2] Acronyms referenced the FANGS or FAAMG, which include Facebook, Amazon, Apple, Microsoft, Netflix, Google and Starbucks.

[3] Is FANG Taking Too Big a Bite Out of the Market? By Zachary Karabell, **Barron's**, June 22, 2017.

The current market conditions require an extra dose of patience as we navigate the uncharted waters of the Fed unwinding its balance sheet, a congress in deadlock, and a stock market approaching nosebleed levels of valuation. As we said in last quarter's letter, "*experience tells us that when stocks are as expensive as they are today, eventually something will change which will return valuations to a more normal level.*" We believe that the consistent application of sound investment principles will allow us to navigate successfully the highs and lows of the capital markets. We will continue to construct a custom-tailored portfolio that will allow us to achieve your long-term investment goals, while helping minimize the risks of permanent capital loss. While it continues to be challenging to find quality companies that are priced at attractive levels for purchase, we will continue to adhere to our investment discipline, regardless of the market's fluctuations.