Third Quarter 2017

Quarterly Letter to Clients

By Scott A. Wendt, CFA

October 20, 2017

The Third Quarter of 2017 may well be remembered as a time of tumultuous change and challenge. Our country continued to wrestle with the strong undercurrents of social unrest and political uncertainty, as it tries to find its collective conscience and reconcile itself to its shifting set of standards. Likewise, the focus on the political front appears to magnify the discontent, and only increases the uncertainty, related to the potential reactions and consequence of escalated tensions between the U.S. and its foreign adversaries. To top it all off, the country has had to deal with four major natural disasters in six weeks, as Mother Nature unleashed three devastating hurricanes in the gulf region and major wildfires in the western part of the country, with losses still being tallied as of this writing. As we head into the final quarter of the year, the world appears to be in flux, almost turned upside down, due to the challenge of recognizing and adapting to the myriad of changes confronting the world at an accelerating pace. Yet through it all, the "Git-R-Done" attitude of most Americans has allowed the U.S. economy to continue to advance, despite the many hurdles placed in its path.

During this quarter, the U.S. economy marked its 99th month of expansion, making it the third longest recovery on record, albeit one with unremarkable growth. This lackluster growth continued in spite of the record levels of fiscal and monetary stimulus injected into the economy since the Great Recession of 2008. In essence, this recovery will carry the twin accolades of being one of the longest and one of the worst recoveries in the post-WWII period, with average annual Real GDP growth remaining stubbornly below 2 ½ percent.

As the consumer remains the major driver of U.S. economic activity, making up almost 70% of Real GDP growth, the continued longevity of this expansion rests in the growth of the components that allow consumers to save and spend. Consumer spending has been growing at about 4%, while disposable personal income growth has faded to 2%. Currently the consumer is making up the difference by increasing their credit card borrowing and dipping into savings. For the economy to sustain or

grow from this point on, acceleration in disposable personal income will be required, either from additional income growth through the combination of higher wages and additional workers hired, or a reduction in income taxes. With unemployment at 4.2%, near the generally accepted level of full employment, the increase in the labor component now seems a low probability. That leaves taxes, which of course is one of the current administration's top initiatives. Without some combination of increased wages or decreased taxes, consumer spending will not be sustainable at its current level, which in turn means that the trend rate of Real GDP growth could drop further.

Tax cuts provide a challenge to a government that continues to spend more than it receives in tax receipts. With deficit spending driving U.S. Treasury Debt to near $20 Trillion, and the possibility of reduced tax receipts from the proposed tax cuts, the ability to use government spending to spur economic activity in a future recession may get increasingly more difficult. Funding unexpected items, like disaster relief, means that policy makers will have less flexibility in implementing effective counter measures to offset any economic slowdown. In addition, the age of the current expansion, combined with the Federal Reserve's less accommodative money policy, means that there is little time to reduce the deficit in this cycle and that higher interest rates almost guarantee that the cost of funding future deficit spending will be higher than it is today.

The Federal Open Market Committee (FOMC) has provided guidance that they will continue to slowly raise short-term interest rates over the next few years, with the goal of targeting a Fed Funds rate at a more "normal" level. Simultaneously, they have announced that they will begin to reverse their Quantitative Easing program (QE), which in essence, was the central bank intervening in the long-maturity spectrum of the bond market by purchasing bonds to force long-term interest rates lower. The readily apparent dilemma is that if the Fed cannot increase the Fed Funds rate to near 3 percent, they will have no ability to react to future economic softness. In addition, the possible impacts from the reversal of the QE program, now dubbed Quantitative Tightening (QT), is not known by any central bankers, since it has never been done before. Clearly, a policy error here by the Fed could have far-reaching implications to an economy that continues to hover at stall speed, or at the very least, neutralize any benefit that the consumer may achieve from the administration's tax and spending initiatives.

BONDS

During the quarter just past, the bond market saw slight 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 3rd quarter yielding 2.33%, nearly unchanged from the end of the prior quarter. Expectations of continued weak inflation, possible changes in the Federal Reserve leadership, and the lack of progress on tax reform all added to bond market uncertainty. However, the upward pressure on interest rates was offset by the flight-to-quality for U.S. Treasuries, due to the increasingly adversarial rhetoric between the U.S. and North Korea. The prospect of further rate hikes, and the aforementioned quantitative tightening, both add additional angst for bond investors who are already nervous about the economic impacts of a more restrictive monetary policy. This put upward pressure on short rates, causing the two-year U.S. Treasury Note to end the quarter at 1.47%, its highest level in almost 9 years.

Morningstar Bond Indexes *As of 9-30-2017*

Broad Market	Quarter	1-Year	3-Year	5-Year
US Core Bd TR Bond	0.8	0.1	2.9	2.2
US Lng Core Bd TR Bond	1.1	(1.0)	4.8	3.5
US Shrt Core Bd TR Bond	0.4	0.7	1.3	1.1
Corporate				
US Corp Bd TR Bond	1.3	2.2	4.0	3.5
US Lng Corp Bd TR Bond	1.8	2.5	5.5	4.5
US Shrt Corp Bd TR Bond	0.7	1.8	2.1	2.0
Government				
US Gov Bd TR Bond	0.3	(1.7)	2.0	1.3
US Lng Gov Bd TR Bond	0.4	(4.9)	4.2	2.5
US Shrt Gov Bd TR Bond	0.3	0.1	0.9	0.7

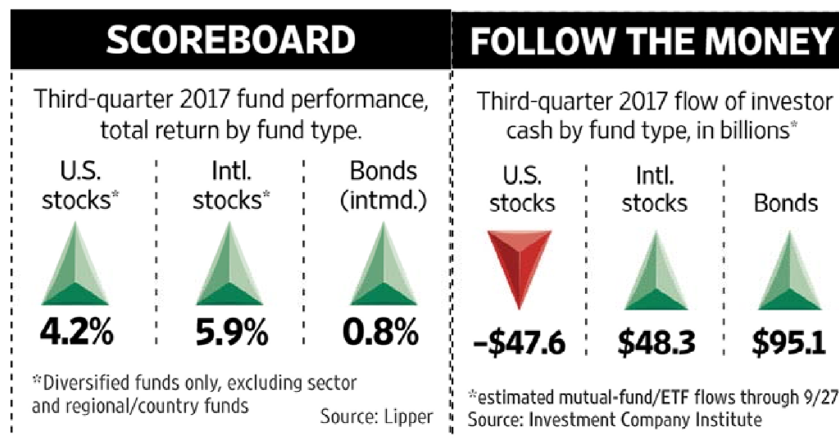
STOCKS

Investors have, at least temporarily, shifted from a Federal Reserve liquidity focus to what the imagined and potential benefits might be for corporate America, should many of the Trump Administration reforms actually take place. The post-election expectations were that:

- The Affordable Care Act would be repealed and replaced;
- Immigration reform would be implemented;
- Tax Reform would reduce individual and corporate income taxes and simplify the tax filing process;
- Deregulation in many industries would reduce the costs of compliance;
- Infrastructure rebuilding would spur economic activity across the nation.

However, the Trump Administration is 0 for 3 on getting a bill through Congress at the present time. Additionally, current stock prices more than discount the upside of lower corporate tax rates, the bill most likely to pass before the 2018 mid-term elections.

Despite the lack of legislative results, stock prices continued to climb the proverbial "wall of worry". As the graphic below shows, the average return for mutual/exchange traded funds that invest domestically in U.S. based companies was 4.2% for the quarter, while those mutual funds/ ETFs that focused on international stocks rose 5.9%. During the third quarter 2017, the flow of investments made by fund type showed withdrawals from U.S. Stock funds of $47.6 billion, while significant cash investments were again made in bond and international stock funds.



WSJ | Journal Reports: Funds & ETFS | Quarterly Analysis | October 8, 2017

The Lipper Performance table on the top of 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 third quarter of 2017, the table illustrates that smaller capitalization stocks performed better than larger capitalization stocks. In addition, for the third quarter in a row, lower quality stocks

outperformed their higher-quality counterparts. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) increased +5.5%, while the S&P 500 was up +4.4%. The tech-heavy NASDAQ posted a gain of +5.8%. The average mutual fund, represented as General Equity in the table, saw a gain of +4.2% for the quarter.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, OCTOBER 9, 2017

	Qtr	1 year	5 year	10 year
S&P 500	4.4	18.0	13.6	6.9
S&P 500 Index P	4.0	16.2	11.8	5.1
Dow Jones Ind. Average P	4.9	22.4	10.8	4.9
NYSE Composite P	3.8	13.9	8.2	2.0
General Equity	4.2	16.8	11.8	6.1
Multi-Cap Growth	5.4	19.9	13.5	7.4
Large-Cap Growth	5.5	20.1	13.9	7.8
Large-Cap Value	3.7	17.2	12.4	5.4
Multi-Cap Value	3.7	16.9	12.5	5.6
Mid-Cap Value	2.6	14.9	12.8	6.9

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

VALUATIONS

Market participants appear to have suspended their normal skepticism and occasional fear in favor of just buying stocks, while shunning the increasingly poor valuation metrics of the stock market. Equities are not being bought because of the quality of their earnings, their long-term prospects, or because they are a screaming value. Instead, investors are buying ETFs and Index funds and rationalizing their investment decisions using strategies like FOMO (Fear of missing out), Big MO (the momentum is pushing the price up, it can't go down) and NEW (Nothing Else Working). In the meantime, the fundamental components of higher stock prices are running out of gas.

Absent a speculative exuberance, the prices of stocks have normally been driven higher by these four factors:

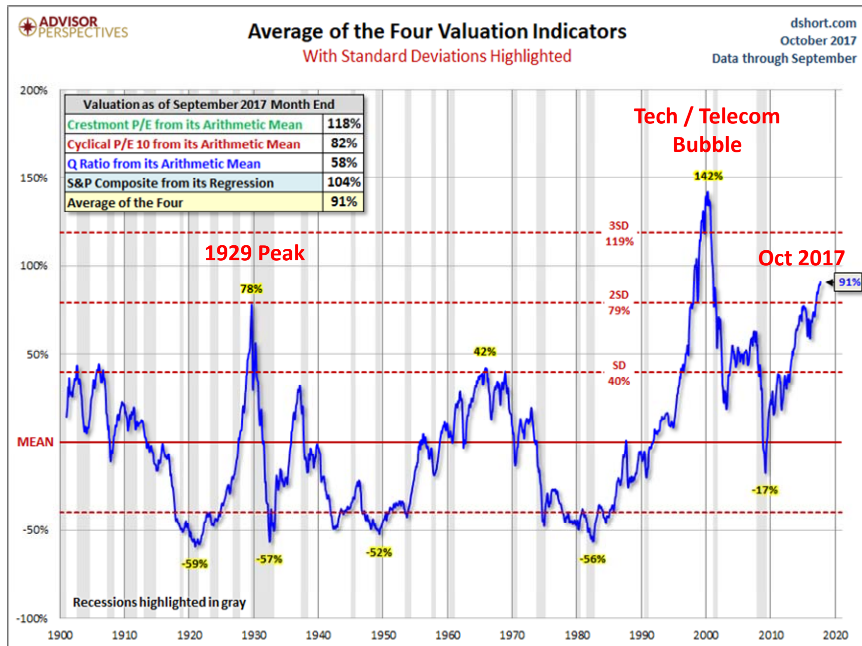
1. Increased operating profit margins,
2. Dividend growth,
3. Declining interest rates,
4. Multiple expansion (i.e. Price / Earnings).

As we pointed out last quarter, operating profit margins have peaked and are declining. Dividends growth has slowed, with a number of companies actually reducing or suspending their dividend this past quarter due to softer cash flow growth and the need to service high levels of corporate debt. Of course, interest rates are on the rise, albeit at a slow pace dictated by the aforementioned shift in the Federal Reserve's policy. That leaves multiple expansion as the final driver of higher stock prices. Investors should be asking themselves what conditions would have to occur to cause the multiple to expand from here? Additionally, if multiple expansion could be justified, how much higher could it go from its present levels to continue to drive stock prices higher?

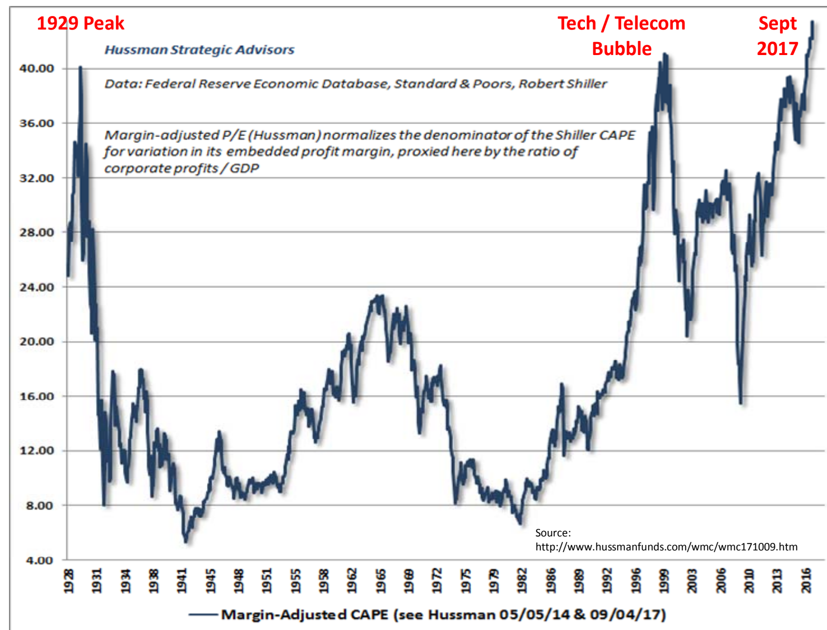
The stock market appears to be exhibiting many of the classic signs of overextension, while continuing to make new record highs. Measures of investor sentiment and greed are at the high end of their respective statistical ranges; while volatility measures continue to bounce along the bottom of their historical range. The current stock market continues to be expensive by most valuation measures, making it vulnerable to shocks that might change the underlying growth trends of the market or the companies that investors own. At the end of the 3rd quarter, the S&P 500 Price / Earnings (P/E) Ratio was 25.5 X, significantly above the 50-year median P/E of 14.7 X. Similarly, the Shiller P/E ratio ended the quarter at 31.1 X, up from last quarter's 30.1 X, also significantly above the its average level of 16.1 X, but slightly below the 32.5 level seen in 1929. [1]

As the chart on the next page suggests, the average of four prominent stock market valuation measures exceeds the levels recorded in the 1929 Peak, and is making its ascension towards the all-time high valuations recorded in the Technology / Telecom Bubble at the turn of the millennium.

[1] Source: http://www.multpl.com/shiller-pe/



Another perspective on the market's current valuation was recently posted on Dr. John Hussman's website. He used the now popular data that comprises the Schiller CAPE P/E ratio and adjusted it for the variations in profit margins over time to provide, in essence, a valuation measure with normalized earnings.



Source: http://www.hussmanfunds.com/wmc/wmc171009.htm

The adjustment to normalize the earnings portion of the CAPE multiple for peak earnings and profit growth is similar to what most analysts do when assessing an individual stock that has a pronounced cycle to its earnings. Hussman's findings show that the normalized CAPE valuation today is at a higher level than experienced in either the 1929 or 2000 peak valuations, on a comparable basis. In addition, Dr. Hussman notes that this measure has a high statistical correlation with subsequent returns (close to -0.90). In layman's terms, this means that a high margin-adjusted P/E will be followed by below average stock performance over the subsequent 10-year time frame. Whether one uses the Average of Four Valuation Measures chart, or the statistically adjusted CAPE Valuation measure, one can come to a similar conclusion – the price paid today for the stock market is significantly above the long-term average.

The question remains: Is this sustainable? Historical comparisons would indicate that, while markets can rise to unexpected valuation levels, the conditions that cause these aberrations do not persist. As stated in our last quarterly letter

> *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. 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."*

A more normal level of stock market valuations are most assuredly going to occur at some point in the future. However, it is nearly impossible to try to predict the timing of when that will occur. As Doug Ramsey, the Chief Investment Officer of the Leuthold Group recently said, "**Major Bull market tops are a process, not an event**."[2] We believe that the consistent application of sound investment principles will allow us to navigate successfully the process of change that is occurring in the capital markets. As such, we will continue to focus our efforts on constructing custom-tailored portfolios that will allow us to help you achieve your long-term investment goals, while helping minimize the risks of permanent capital loss.

[2] Bracing for the Aging Bull Market's Last Hurrah, by Leslie P. Norton, **Barron's**, August 26, 2017.