Lodestar Investment Counsel, LLC
150 S. Wacker Drive, Suite 3050
Chicago, IL 60606

Telephone: 312.630.9666
www.ldstr.com

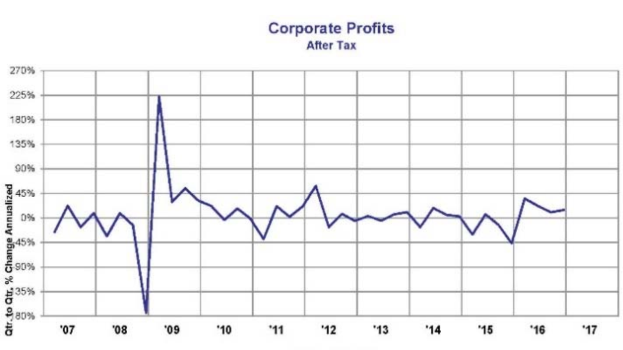
LODESTAR

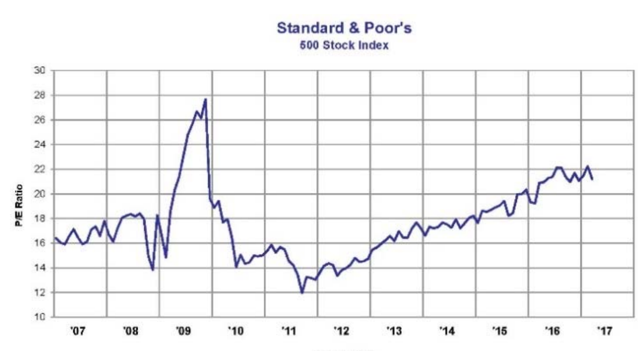
MARCH 31, 2017 INVESTMENT MARKET COMMENTARY

Rising interest rates, economic policy uncertainty, US political intrigue, North Korean nuclear threats, unpredictable presidential tweets, and seemingly ever present high valuations could not stop the stock market's upward march over the past quarter. Nor has age done much to sap the energy from this bull market as **the current upswing recently commenced its ninth year, a stretch of longevity rarely experienced**. On average, stocks correct 20% or more every three years. Yet, despite persistent challenges facing the US and global economies, a decline of this magnitude has not occurred since the financial crisis of 2008/2009. **More recently, a wave of post-election enthusiasm for policies that should be business and investor friendly has buoyed asset prices; time will tell if this optimism is justified.**

While equities have advanced nicely thus far in 2017, bond returns have been only slightly positive as interest rates have generally stabilized following the sharp rise late last year. With anticipation high as to possible pro-growth economic initiatives, the financial markets are now awaiting the outcomes of policy decisions that will bear on asset prices. **Remarkably, this past quarter was the least volatile period for stock prices since 1965, despite what seems to be breaking news of significance on almost a daily basis.** It provides little comfort that the investment markets are hostage to the machinations of politicians. For example, the recent failure to pass health care legislation injected doubt about future policy measures into the investment equation. **Indeed, it appears that a market inflection point may be developing, one that could have significant repercussions based on the success or failure of government driven policymaking.**

The stock market is discounting future strength in profits; in the past quarter corporate earnings are expected to have grown at the highest rate since 2011. However, the sustainability of this uptick in economic activity is unclear. 'Soft' data, mostly sentiment indicators such as consumer confidence and business optimism, are at elevated levels not seen since 2000. However, 'hard' data, including actual measures of economic activity such as retail sales and capital spending, are not so positive. The charts below tell the tale. Business profitability has stumbled along, yet investors have been willing to pay increasingly more for a mediocre profit picture.





<u>Reasons to be Cautious…and Optimistic</u>

The present economic and investment landscape contains a number of paradoxes that are likely to resolve, one way or another, in the not too distant future. Consider the following:

- The current stock bull market is one of the longest in history despite one of the worst post-recession periods of corporate earnings growth. Stock gains have mainly come from expanding price/earnings multiples and not increased business profitability. That disconnect cannot last indefinitely.

- Enormous expansion of US government debt has occurred while at the same time the value of the US dollar has strengthened and interest rates have been at historically low levels in recent years. Ordinarily, debt growth of this magnitude would cause concern for the currency and lead to higher than normal bond yields, but not the case in this cycle.

- From an international perspective, the US remains the perceived safe haven as evidenced by global inflows of capital during periodic times of global stress. This status continues today despite the appearance of seemingly irreconcilable dysfunction of the US political/governing system. In short, the US, in many respects, is the best house in a challenged global neighborhood.

Most recent indicators reveal that investor concern has been replaced with confidence, and even complacency. Wall Street's 'fear gauge', a measure of volatility, currently sits at its lowest level in decades. Yet, while low interest rates and animal spirits may drive equities higher for a time, it is fair to suggest that a sell-off will occur if profits do not rise meaningfully to justify above average valuations. **The bottom line is that whether one believes in the economic turnaround thesis, or remains unconvinced, it is clear that earnings growth will be the key factor if the bull market in stocks is to be sustained.** Our hope is that tax and regulatory reform, designed to jump-start a sluggish economy, will be enacted to the benefit of many constituencies including workers, businesses and investors.

Many market pundits are calling for the long awaited correction or 'bear' market. They may well be right, though virtually all major bull markets end when euphoria is the dominant emotion and this is not the case today. **So long as the economy remains growing and interest rates do not rise sharply, market conditions are not ripe for a major decline. Having said that, we do anticipate volatility to increase, due mainly to the ebbs and flows of uncertainty around government policy.** Of course, uncertainty is why a long-term investment approach is critical to successfully growing your money over time. While never easy, those who have weathered significant market downdrafts, and have preferably taken advantage of such opportunities, not only recouped paper losses but ended up with larger portfolios as recoveries took hold. **Recently, it seems that much has changed in the world, yet the time tested approach to wise investing remains the same. Ultimate success depends on not allowing the ever present 'noise' to unduly influence decision making, and maintaining discipline in pursuing a well-conceived strategy that takes into account both potential near-term risk and long-term return.**