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SEPTEMBER 30, 2017 INVESTMENT MARKET COMMENTARY

Over the past three months, stock markets around the globe marched inexorably higher as many of the key issues that have impacted the investment backdrop in recent years continued unabated. After a brief spasm in August, volatility returned to historically low levels, 'growth' stocks outperformed 'value', and despite the consensus view that interest rates should move higher, yields were virtually unchanged. Digging a little deeper, lower quality and high beta equities were the best performers, suggesting that, together with muted volatility, investors remain highly confident and/or complacent. Interestingly, the month of September, historically the worst for stocks, was the least volatile of any year since 1928. Finally, as has been the case for some time, bonds delivered modest returns. In this environment, fixed income securities will not likely provide outsized returns but should deliver safe and consistent income streams, and protect principal through adverse markets.

Some Thoughts on the Market Environment

In conversations with clients and friends of late, a few common topics and questions often surface. The following are our thoughts and perspectives on these issues:

1. **Why are stocks so expensive?**

   It is true that stock valuations have exceeded historic norms for the past several years as price appreciation has meaningfully outpaced corporate earnings growth over this timeframe. Annual equity market gains have become the norm since the bottom of the 2008/2009 financial crisis, an astounding feat given that the economy has only grown about 2% annually, which historically is a fairly mediocre post-recession rate of recovery. Why have investors been willing to pay up for company earnings that are growing at a modest pace? We see two primary reasons: 1) the exceedingly low interest rate environment has made alternatives to stocks much less appealing, thus investors have shrugged and stayed the course (leading to the overall low market volatility), and 2) the slow but steady recovery of the US economy and, as importantly, most foreign economies, has provided the expectation that corporate earnings growth will improve and recession risk is low.

2. **Given obvious and considerable uncertainties and risks, why has the market not experienced even a minor correction for well over a year?**

   Greater demand for stocks and a dramatically lower supply of them (half as many publicly traded companies as in 1998), together with an absence of investor euphoria, partially explains the lack of a pullback. These factors, combined with the 'easy money' policies of the Federal Reserve, have provided the fuel to drive equities to record levels. The lack of investor giddiness, despite the elongated market advance, is particularly surprising and important. Stocks typically fall when public enthusiasm becomes excessive. In other words, once investors are ebullient, there are fewer buyers to support already high prices. Because of the subdued economic environment here and abroad, and the plethora of other concerns (including geopolitical strife, terrorism, and political dysfunction), investor euphoria has been missing from the equation. Lastly, inertia has set in with some investors, as the consistent rise in prices, and lack of scary volatility, has fostered complacency.

3. **How is it that the market is holding up when the new administrations reform proposals have not yet been enacted?**

   After years of tough times brought on by the financial crisis, economies worldwide are generally improving or at least muddling along. Specifically, business activity is trending up, unemployment is declining, leading indicators are making new highs, and inflation is modest. These facts go a long way to explain why stocks refuse to pull back in the face of bamboozling inactivity from our nationally elected officials. Moreover, many, if not most, investors remain hopeful for some positive tax reform. As part of the tax initiative, equity investors are expecting corporate tax rates to be reduced which would increase company earnings and make stocks more appealing. To some extent current stock price levels assume that this tax reduction will occur; should this reform fail to materialize the markets would likely respond negatively.

4. **Why are interest rates staying so low and not above the level of inflation?**

   Despite unprecedented efforts by the US Federal Reserve and foreign central banks, interest rates and inflation remain well below normal. Historically, 10-year treasury bond yields are typically 2.0% or so higher than inflation; today they are roughly at the same level. There is no doubt that rates have been artificially suppressed by the ongoing central bank stimulus programs, but there are other reasons as well. For example, due to the low interest rates, many investors are seeking income wherever it is available, thus driving up the demand for bonds and, consequently, keeping yields low. In addition, given the several areas of concern previously noted, there is considerable demand for quality assets that will protect against market unrest. Earlier this year, the Fed announced plans to gradually increase rates and reduce the amount of bonds they hold. We hope this action will begin to normalize yields to the point where bonds are not simply safe investments, but attractive ones as well. Having said this, one of the more salient risks facing the markets would be a sharp rise in rates over a short period of time; conversely, a gradual rise over the next few years would not likely be surprising or too upsetting to the markets.

Looking Ahead

Compelling stock market opportunities are currently limited because of price, and it is widely recognized that a pullback is long over-due (stocks have not fallen by as much as 5% for more than 14 months). While the economic backdrop is generally supportive of financial assets, there is certainly no absence of warning signs of potential risk. Perhaps forgetting the pain of the last financial crisis, some investors are now speculating where the odds appear unfavorable. For instance, bitcoin, and other "cryptocurrencies", have soared in price in recent months. As these computer generated "coins" have zero intrinsic value, it is likely they will meet the same ignominious end as did the Dutch Tulip mania of the 1600's. Additionally, desperate for securities that pay more than government bonds, some institutional investors have returned to buying synthetic CDO's (collateralized debt obligations), the very same instruments that caused the last financial crisis. Finally, Argentina, not exactly a gilt edged credit, recently was able to sell 100-year bonds, reflecting the willingness of certain investors to assume risk that is nearly incalculable. These several developments exemplify how the investment environment has become a bit more speculative, a condition that warrants close monitoring.

None of this means that the investment markets are facing imminent retreat. We make these points to emphasize that, for some, complacency has set in and fairly obvious risks are going unappreciated. We intend to stick to our knitting, buying quality when it represents good value, and maintaining asset allocations that are appropriate in order to meet your financial objectives.