July 2017 Thoughts and Insights

Happy Summer to all!

Despite all the turmoil in the first half of the year, the markets have been very rewarding for our portfolios. Both our equity and fixed income positions have done well, and we don't anticipate any huge changes from the status quo. So, as I thought about what topic I'd like to address in this quarterly letter, I realized that as I talk to and meet with clients the dominant topic/concerns they have are about the significant political uncertainty in Washington, and why it has not had a deleterious impact on the stock market. This topic alone could take up the full newsletter, and I'm happy to have a chat over the phone or a glass of wine with any willing souls on this subject. Clients have also been concerned with valuations as equity markets flirt with all-time highs. And lastly, there is a bit of uneasiness surrounding Fed policy and if the central bankers may be raising rates too soon. So let's discuss.

President Donald Trump campaigned on promises of sweeping reform, and the stock market is up 14% since he took office. However, six months after his inauguration there have been delays in achieving health care reform, tax reform and other perceived pro-growth policies (not to mention all the other scandals that are not market related). Many investors perceived that the run up since Trump was elected was due to the expectation of reform, yet despite these delays (and other drama) stocks have not suffered any significant negative impact.

We believe that the gains during the first half of the year are unrelated to election expectations, but due to a strong economy. If we extract the "noise" from Washington and look at the economy, there are many positive factors at play. The job market is strong (June added 220,000 new jobs) and unemployment is low at 4.4%. The Institute for Supply Management readings also point to stronger growth, and the US real GDP could approach 3% in the third quarter. Lastly, corporate earnings have been strong and have met or exceeded analysts' expectations. In summary, the markets are pricing equities on their fundamentals and not on political uncertainty. Despite all the craziness out of Washington, we will remain focused on the economy and how it relates to our investments.

What about valuations? Yes, they are elevated but in the context of low inflation, still low interest rates, and ample market liquidity the stock market can support them. If we only look at the nominal price-to-earnings ratio (P/E), the market would not be considered cheap. However, if we compare the earnings yield of the S&P 500 at 5.3% versus the 10 year Treasury at 2.3%, equities look far more appealing today on a relative basis.

We expect that the global economy will continue to grow, albeit slowly, and that we are in the late stages of the growth cycle. This phase could be marked by bouts of volatility and/or pullbacks. Given the current low volatility environment, any decline could easily lead to a selloff of perhaps up to 10%. We think that this type of "washout" could be a healthy catalyst that could send stocks to new highs by mid-Autumn. If/when this occurs, we are ready to add to our equity positions.

Finally, the Fed. The Fed is attempting to unwind the quantitative easing program it employed during the financial crisis by gently raising short-term interest rates which dropped to near zero for the past 8 years. At the same time, it is also looking to scale back some of the roughly $4.5 trillion of assets currently sitting on its balance sheet that it purchased to inject more money into a wobbly economy. In theory, tightening monetary policy should slow economic growth, ideally just enough to keep inflation in check without choking off economic growth. Tightening too much or too fast could pose a risk to the economy, which is why investors are keeping a close eye on the Fed's next moves. Interestingly, since the Fed began raising the federal funds rate in December of 2015 financial conditions have actually loosened. This is also why the stock market has remained so strong.

I hope I have answered some questions that you may have had about the current investment environment. If not please don't hesitate to call or take me up on my offer of wine.

There is one last topic of huge interest and concern that we would like to address as we close this letter. Cyber fraud has become a real hindrance and threat to all of us. We have added a supplemental note to help guide you through steps that can be taken to improve the security of your financial data.

As always, we remain dedicated to serving your investment needs according to your goals. Please call or write with any questions or concerns you may have.

Michelle & Jim