MID-QUARTER UPDATE – FEBRUARY 2017

Stocks have continued to trade higher thus far in 2017. Justified or not, it seems that Trump euphoria has a firm hold on markets, with expectations for tax cuts, less regulation, higher earnings growth, and global reflation. As of this writing, the S&P 500 benchmark has advanced approximately 4% year-to-date through mid-February. Bonds have advanced slightly, with the Barclays Aggregate up 0.5% during the period. Stocks have traded along with news from the White House, selling off on reports that Trump's economic agenda is being pushed out and then rallying on tweets that a "phenomenal" tax package is just around the corner. While we are certainly enjoying these moves higher, one cannot help but get a bit cautious at these valuations, as the market may be "priced for perfection" and that reality could bring some disappointment.

While there are reasons to expect the good times to continue, it is important to be vigilant given that throughout history high valuations, excessive optimism, and low volatility are indicative of past market tops. Domestic stocks are at the highest valuation since the tech stock mania in the late 1990s, which leaves room for plenty of disappointment should earnings growth and overall economic prospects not deliver on current lofty expectations. As I write this newsletter, all four of the major domestic benchmarks: the S&P 500, Dow Jones Industrial Average, NASDAQ Composite, and Russell 2000, are setting all time highs as investors continue to trickle into this market, not wanting to be left out. It is a dangerous mix when prices are high and expected market volatility is low. To make this point, the VIX index measures the implied volatility of the S&P 500 Index as priced by the options market. At today's reading of under 11, we are at levels not seen since a brief point in 2014 and then all the way back when the market peaked in 2007 just before the financial crisis. Cash levels held by fund managers are another gauge of sentiment, as low cash levels are consistent with a state of high optimism, where little exists in the way of buying power to move the markets higher. As reported in the July 31 daily Sentiment Report from *SentimenTrader*, "Fund managers are holding the least cash in history". Any time I see a statistic referencing a historic anomaly, I take notice.

Economists are anticipating three rate hikes this year by the Fed, and while they have been wrong before, as the Fed has acted more slowly than anticipated in the past several years, this time could be different. For one, the market itself believes the forecast and is currently pricing in two and a half rate increases as measured by Fed Fund futures. Further upticks in inflation and continued improvement in the employment situation make the case for higher rates much more likely than in years gone by. Most investors understand that, all things equal, rising rates are considered a negative for bonds, as prices shift lower to account for the fixed interest payments becoming less attractive in a higher rate environment. However, higher rates can be a negative for stocks at very high valuation levels, as well. Rising rates make the current price/earnings multiple of nearly 20 for stocks less justified because the discount rate on future earnings is higher and the relative attractiveness of bonds versus stocks shifts when bonds pay more. If declining interest rates and the Fed's Quantitative Easing programs led stocks higher during this recovery, then rising rates could have the opposite effect.

I do not want to sound like the future is doom and gloom, because it is not. Earnings should improve and the Main Street economy could see a substantial improvement under more stimulative policies.

Lower taxes, less regulation, and business friendly policies are all positives for asset prices, and the new President is taking direct aim at improving economic output. We just want to keep the hype in check. When optimism moves to extreme levels along with prices in valuations, then we feel skepticism is warranted.

For this reason having a diverse portfolio including alternative investments and tactical investment strategies where appropriate for specific clients may make some sense. Standing ready to sell and reduce risk for certain parts of the portfolio could be prudent for clients on a case by case basis. Owning stocks in foreign countries that are more attractively priced than domestic stocks (despite not having performed as well over the past five years) also may make plenty of sense in the coming years. Positioning in Alternative Investments for a portion of some accounts as appropriate may pay off nicely in the future, despite several years of meager returns from the diversifying asset class. Assets move in and out of favor, and certainly US stocks have been squarely in favor for nearly this entire recovery since 2009. Diversifying away from the expensive names and including some of the more opportunistic investments could be positioning for tomorrow's winners today.

We are not in the business of calling market tops and bottoms. We do not play the game of "guessing" where the market could be at the end of the year, either. Instead we measure current fundamentals, valuations, risks, and trends and allocate client portfolios and strategies to the best of our ability. As of this writing we are not positioning for the market to reverse course in the near future, but we stand vigilant with the prospect that stocks could be vulnerable at these levels at some point in the future, and some positioning down the road may be appropriate. In the meantime we want to enjoy the current trends, but keep optimism in realistic check.

All the best,

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