MID-QUARTER UPDATE – NOVEMBER 2017

As we approach the Thanksgiving Holiday investors certainly have plenty to be thankful for, as the strength in the equity markets continued since our last update. As of this writing, almost all major stock indices are up significantly on a year to date basis and are at or close to all time highs. After lagging the U.S. markets for several years, foreign stocks have outpaced the U.S. for the last year. Thus far in 2017, developed international (MSCI EAFE) is up about 18%, while emerging markets (MSCI Emerging Markets) are up around 30%. Interestingly, a large portion of that performance has to do with weakness of the dollar, as those same indices are up approximately 11% and 27%, respectively, in local currency terms. Domestically, the S&P 500 is up 15% YTD, while mid cap (S&P 400) and small cap stocks (S&P 600) are up 10% and 7%, respectively.

This performance has been backed by strong economic fundamentals, with a backdrop of low unemployment and strong earnings growth. Yes, the S&P 500 is currently trading at about 24 times earnings, which is expensive by historical standards, but with consensus earnings estimates projected to grow about 11% next year, the forward price to earnings ratio is a more reasonable 17.6 times earnings. Valuations are more compelling when looking at foreign and emerging market indices, where the forward earnings multiples are at 14.9 for the MSCI EAFE and 12.5 for the MSCI EM. In addition to the strong earning reports we have seen, the market optimism seems to also stem from hopes of tax reform, with House Republicans recently submitting the "Tax Cuts and Jobs Act of 2017". Although it is still early and much will likely change, the bill proposes to cut the corporate tax rate from 35% to 20%, replace the current seven tax brackets for individuals with four brackets, and potentially repeal the Alternative Minimum Tax. This is an oversimplification of the proposal at this point, and we are sure there will be revisions, but suffice to say that the equity markets appear to be factoring in some form of passage.

Volatility remains exceedingly low in the equity markets, and we worry about investor complacency. As we have mentioned in past newsletters, this year marks the lowest volatility readings in history, whether using the VIX Volatility index, average daily change, or maximum drawdown before full recovery as a gauge of volatility. As a matter of fact, the market has never experienced a calendar year without a single negative, month but we are on pace to achieve that accomplishment if the markets can oblige for another six weeks.

While the markets quietly advance, a look under the hood shows the potential beginnings of troubling signs. Market breadth refers to how wide the participation is across markets and sectors. An advance with robust participation across industries is said to have strong breadth and the move is expected to continue. At market tops, market participation tends to splinter with large numbers of sectors beginning to show weakness before manifesting in declines across broad market averages. Market breadth has been deteriorating over the past month. According to SentimenTrader, 30% of the S&P 500 stocks are trading below their 200 day moving average (a level used by many to determine if s stock is in a bull or bear market), which has only happened three times since 1990 – including the market highs of 2000 and 2007 (the fourth was July 1998).

In the fixed income markets, however, volatility has picked up a bit over the last year. Immediately following last year's election, interest rates increased considerably as the markets digested the prospect of more inflationary policies. While those concerns seemed to subside in the first half of the year as market participants attempted to distinguish between political rhetoric and actual policy, in the last couple of months the focus has shifted back to the Federal Reserve. First, we have discussed in recent newsletters that the Federal Reserve plans to reduce the size of their $4.5 trillion balance sheet, which has expanded from about $905 billion before the 2008 crisis. The unwinding process that started in October, according to the note issued by the Federal Open Market Committee on September 20, arguably should place upward pressure on interest rates if one of the largest buyers of fixed income securities for the last several years is moving to the sidelines. Second, Jerome Powell was recently nominated as the next chairman of the Federal Reserve. If confirmed by the Senate, it is not expected that his policies would diverge much from the dovish, low interest rate policies of his predecessor, Janet Yellen. Finally, the fixed income markets seem to be pricing in another increase in the Fed Funds rate at the December meeting. Regardless of the short term direction of interest rates, we feel that it will be difficult for investors to earn high returns on fixed income investments in an environment where the yield on the 10 year U.S. Treasury is a mere 2.38%. In many fixed income portfolios, we continue to manage at least a portion in a tactical manner so we can capture some yield without taking on too much risk.

Are we getting to levels that might be described as "irrational exuberance" as former Federal Reserve Chairman Alan Greenspan once quipped back in 1996? Quite possibly, but we should remember that the markets pressed higher for another three years after his quote. It is interesting to note that as the markets moved higher this year, with very little volatility, the Nobel Prize in Economics was awarded to Richard Thaler from the University of Chicago. Professor Thaler won the award for his work in the field of behavioral economics. Much of his work focuses on the fact that individuals do NOT act rationally, so the real life economic decisions individuals make do not always correlate to what might seem to be a common sense response. Human nature is such that as markets move higher, and stock returns far outpace other asset classes, individuals often question if they should have more stocks, not less. Rarely do we field questions from clients about adding to areas that have underperformed.

The balancing act for us as advisors is to place our clients in portfolios that they can stick with during both good times and bad, trying to capture upside performance when it is appropriate to do so without losing sight of the downside risks. At the end of the day, we are helping people achieve their financial goals, whether it is retirement, college funding, providing growth and income for an endowment, or a number of other objectives. In short, we manage to a goal for most clients, not merely to an index.

As markets become extended, we should all become less concerned with maintaining pace with an index and more focused on avoiding mistakes that would negatively impact our ability to reach those goals. As such, we continue to try and stay nimble in client portfolios and focus on risk adjusted returns, as opposed to squeezing out every last ounce of gain in the current rally.

I would like to take this opportunity to wish you and your family a happy holiday season!

OPERATIONAL NOTES

- **<u>An important note regarding checks</u>: Please include your account number in the memo section on any checks that are sent to us for deposit.** If you do not know your account number, please feel free to call the office for this information. As always, checks should be made payable directly to the custodian (Fidelity, TD Ameritrade or Charles Schwab) and never made payable to Grimes & Company. Unfortunately, we will be required to return any checks that are not filled out properly.

- As we approach year end, just a reminder that any gifting for 2017 would need to be completed by December 31. Remember that low cost basis securities can be attractive charitable contributions, and if you have any questions on this please contact our office.

- For clients age 70 ½ or older this year, remember that the Required Minimum Distribution (RMD) from your IRA or other qualified plan(s) must be taken by December 31. (If you are just turning 70 ½ this year, you do have until April 1 of next year to take the first RMD.) If you have any questions regarding your RMD, please do not hesitate to contact us.

- The IRS has extended the tax deductibility of using RMD proceeds as deductible charitable contributions. The RMD must be sent directly to the charity. Remember that these take time to process and our custodians (Fidelity, TD Ameritrade and Schwab) recommend processing them by early December to ensure that they occur in 2017

- For those of you who spend the winter somewhere other than your primary residence, please let us know if when you are leaving for the winter so we can update your primary mailing and telephone information accordingly.

All the Best,

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Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet.

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