INVESTMENT THOUGHTS

MARCH 2018

THE VIEW FROM OUR WINDOW

From the coaching department:

Certainly there is an ample supply of nettlesome variables to trouble investors today; political provocations, central bank policy uncertainty, elections, scandals, market sell-offs, old wars and new ones etc. Managing an investment portfolio in this environment, especially a retirement portfolio, is serious business. Decisions can have consequences in real time that can affect one's confidence and feelings of well-being. Letting events create worry and fear can actually harm one's ability to make good judgments. It may seem a platitude, but whereas we know the markets are not in our control, we can still choose our attitude in how we evaluate the circumstances. Having a persistent sense of purpose in mind for your portfolio is a necessary condition to reduce worrisome distractions from daily financial news. Think for yourself and about your own priorities without trying to follow popular investment trends of the herd. Pursuing your own goals by following a long-term plan removes you from the emotional lure of daily noise. There is no portfolio that can be optimal for all circumstances at once. A defensive portfolio will lack momentum in quick upmarkets or an aggressive growth portfolio may experience extra volatility. Focus on yourself as the investment benchmark and consider all of the wealth management steps you have taken to meet your needs and why they were taken.

Select market and economic items we are following:

The drop in the S&P 500 in February was the first decline greater than 10% since 2016. The bounce off the February 9th low has relieved some of the unease that it would become something worse. Meantime corporate earnings are delivering an upbeat message. Trading sentiment is now focused on the Federal Reserve and its new chairman. In the month of February, technology and consumer sectors did best and interest sensitive real estate investment trusts fared the worst. Market

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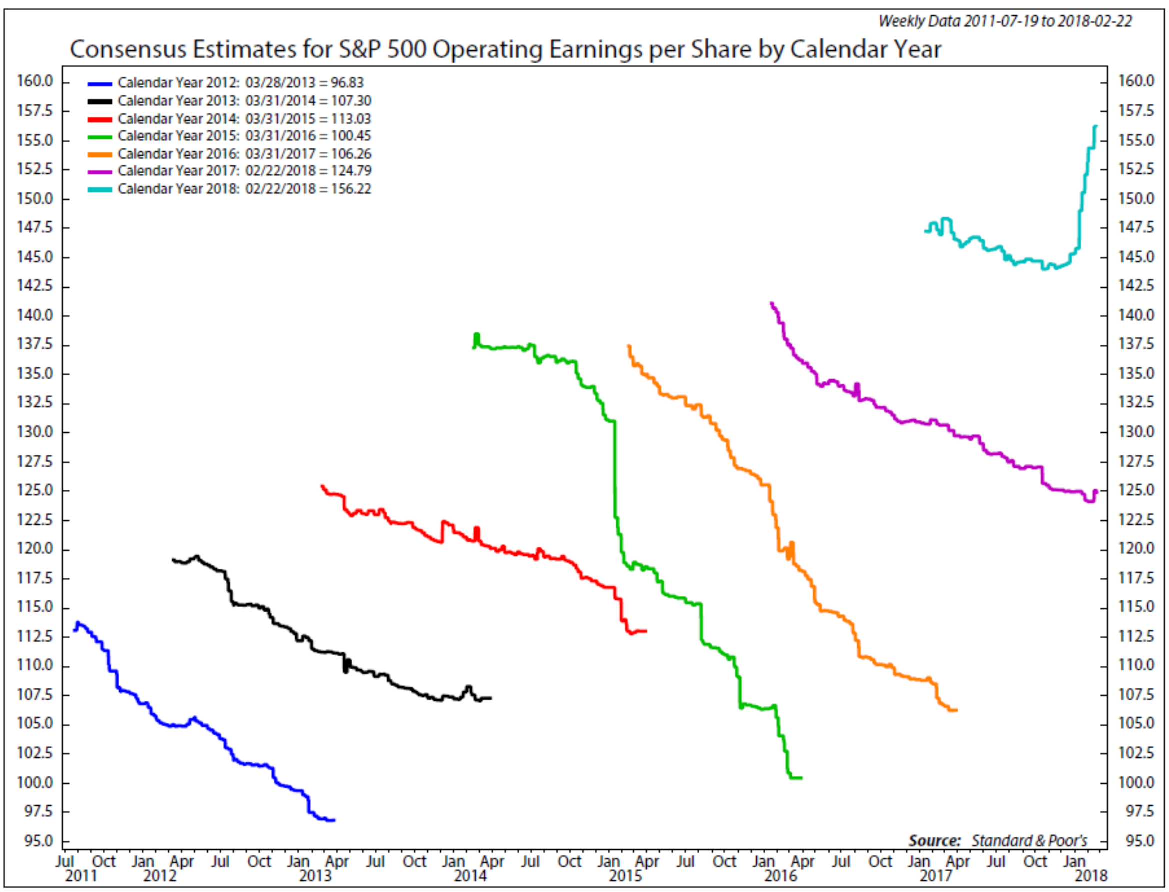
leadership should see financial stocks gain relatively as they benefit from rising rates. The key is the path of bond yields and corporate earnings.

Today the stock market fears what the bond market is saying about rising inflation and interest rates. For its part, the bond market fears what the Fed will do with interest rate hikes this year. A cross current of rising corporate earnings and rising rates has set up a two-sided competition; will earnings grow enough to offset higher rates? The answer, we believe, will point to stocks as besting the returns of bonds. Strong sales, tax cuts and stock buy backs are tailwinds for stocks to absorb higher rates. However, the market's elevated valuation as measured by P/E ratios and cash flows means that factors like rate hikes will have a larger effect on the market price via the price to earnings number and will lead to greater volatility. **Chart #1** shows consensus estimates for the S&P 500 by calendar year. Note that for 2018 estimates have surged to $156.22, up 25% from 2017 of $124.79.

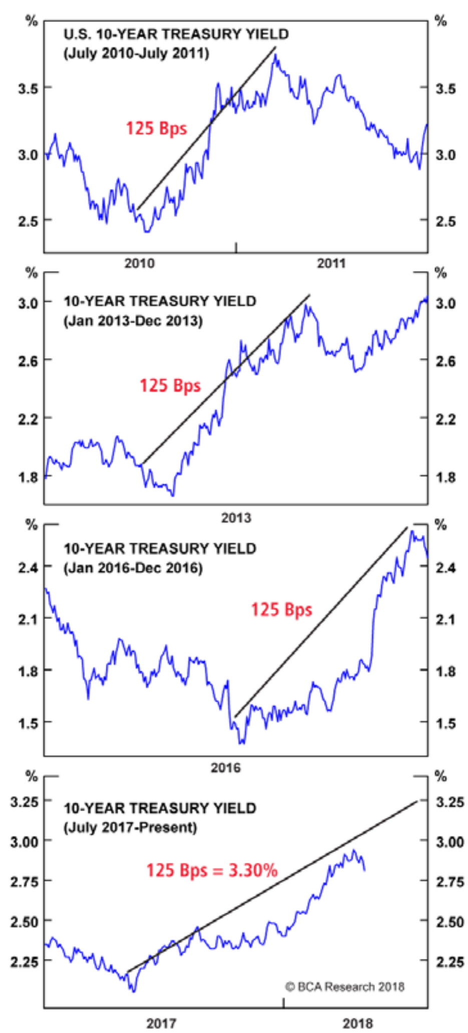
Chart #1



Elsewhere, the US consumer seems reasonably comfortable and confident to spend. In a reading from the Bloomberg Comfort Index, both confidence and comfort are at the highest levels since 2004. We think this bodes well for consumer spending this year, a large share of our economy.

Harking back to the competition between stocks (earnings) and bonds (yields), we note that the bulk of the rise in rates, so far, has been heavily influenced by expected changes in the Fed's policy rates. The concern in markets is for an increase in rates to take place 3-4 times in 2018. There is only so much tightening over a short time the economy and markets can take before creating a recession scare that infects consumer spending and housing. 1.25 percentage points of tightening in a year is about the limit, after which yields begin to fall on economic contraction concerns. **Chart #2** from BCA Research chronicles past tightening periods and the response of the 10 year Treasury note yield. In the current period it suggests a rise to 3.3%-3.5% may be the limit.

Chart #2



Rising rates to a tipping point or beyond is not a certainty. Keep in mind the end of zero rates has already had some impact due to the fact that financial leverage (borrowing) is still high and many firms have borrowed in the bond market to buy back their stock, weakening their balance sheets. Housing and autos could lose momentum quickly if the Fed is too aggressive. There is another reason we do not feel rates will reach a harmful level; namely, the Fed needs to unload bonds it bought since 2008 to push rates down. This will be a limiting factor on both pace and size of any policy action. The inflation dynamic also comes into play and today it is made more interesting as it is not only price increases from the likes of healthcare, energy, housing and food, but advances in technology can hold prices down. Just the Amazon effect alone is deflationary. Remember when Wal-Mart began importing deflation from China, importing cheaper goods and cutting US prices. Globalization and cheaper labor abroad have also tempered inflation. Income inequality also has a part. Corporation's share of profits has risen relative to labor and the wealthy who own stocks have gained the larger share from the past bull market. Since the wealthy spend a smaller percent of income on consumption compared to low income households, the Trump tax cuts spending push will be muted. Wage growth for the bottom earners won't set off any trouble. We are following the spending of Millennials and retired Baby Boomers. The Millennials are a larger group that seems ready to spend on household formation not withstanding their student loans. Baby Boomers spending will slow outside of healthcare. Inflation is building, but not as fast as the market reaction has reflected. Stay with stocks and short duration, high quality bonds. Problems will pop up in the coming days. Don't let them defeat you with worry. Try to think of them as opportunities in work clothes. (Henry Kaiser)

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