Market Commentary - October 2017

CLEARVIEW
WEALTH SOLUTIONS

Q & A

Once a year we share the most frequently asked questions by both clients and attendees at our presentations to fellow professionals.

Can the 'Energizer bunny' stock market rally continue with all the headwinds including rich valuations, North Korea, and a tighter Fed policy among others?

Yes, we think it can for a while longer but we should first point out that the broader market has been flat since mid-June. A small basket of mega-cap tech stocks is responsible for the almost daily new highs.

Earnings are the key here. Expected earnings growth for the S&P 500 is 9.6% for 2017 and 10.9% for 2018 (source: FactSet). If actual growth numbers are as robust as forecast, earnings may support even higher stock prices.

What stock market related factors keep you up at night?

Even in the sweet spot of a bull market, there are always numerous factors that could derail the bull. This late stage bull market is no different. Here a few major factors that concern us:

- If the Fed raises rates too much or too quickly, both our economy and markets would likely suffer. And, if the yield curve becomes inverted (long rates lower than short rates), many investors, including us, would be on the lookout for the next recession.
- Investors remain hopeful for at least a few legislative victories for the Trump administration. Corporate tax reform (including repatriation of cash) would add up to $10 to 2018 S&P 500 earnings, or about 7% in incremental growth. Our concern is the expected reform package may be watered down and disappoint investors who have already factored in higher earnings estimates.
- Valuations based on traditional metrics continue to concern us as we have mentioned many times. A new statistic we found disturbing is financial assets are now the richest they have ever been at 3.3x worldwide GDP (Sources: Morgan Stanley and Deutsche Bank research). This is important because extremely high valuations have proven unsustainable in the past.

Do you adjust your required valuation metrics (ratios) for stock purchases based on the level of the stock market?

No.

We are always looking to get more for less. We want more growth than other stocks in the industry or the market but with valuations substantially below the market or the industry norm. We may have to pay higher P/E multiples than we did earlier in the bull market, but we stand firm on metrics like the P/E to growth ratio to name one. In general, our valuation ratio requirements do not change based on the level of the market which makes finding new stocks to buy difficult in this market.

You don't make a lot of changes in my equity portfolio. What is your turnover rate and what triggers a change?

Our turnover rate differs by equity strategy but averages about 15%-25%. Equity choices based on solid fundamental research should be held for a number of years-the longer the better in our view.

Our triggers to make changes (our sell parameters) include:

- Valuation becomes excessive
- Position sizes become too large because of appreciation (we trim positions)
- Business fundamentals deteriorate
- Sector strategy changes
- We find better opportunities elsewhere
- Desired risk profile of portfolio changes

Although there are a number of triggers, they usually do not occur often. We always look for reasons **not** to make changes unless absolutely necessary.

What does the recent reversal of accommodative policy on the part of the Fed mean to the economy and my bond portfolio?

This is an especially important time to take stock of bond portfolios because the Federal Reserve in now unwinding its one-off monetary accommodation of the past several years. As this balance sheet program (QE) is unwound, and other central bankers are compelled to follow suit, it is highly likely that some market liquidity will be lost. Further, higher rates will also be a part of this normalization with current projected over-night funds rates at or near 2.25% by year-end 2018 (about where 10-year T-notes are today). This could push T-note rates up by nearly as much. Should the Fed follow through with their plan, higher rates will make funding more expensive for all and thus have a negative impact on bond prices, borrowing and the economy in general.

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