Market Commentary - September 2017

CLEARVIEW WEALTH SOLUTIONS

Growth stocks have outperformed value stocks by a wide margin this year; 16.8% YTD compared to 4.3% (as measured by the Russell 1000 growth and value indexes). In fact, growth stocks have outperformed value stocks by 3% per year for the last 10 years. We have also seen periods where value stocks had multi-year outperformance runs.

Is there a way investors can profit from these style cycles? We don't think so. Anticipating which style of investing will have the upper hand is as difficult and fruitless as market timing, in our opinion. Instead we own both growth and value stocks in client portfolios and don't concern ourselves with unpredictable style cycles.

Smoking the Last Puff of a Cigarette Butt

Warren Buffet used this phrase when describing stocks with limited upside-one puff remaining. Actually, Buffet is only interested in stocks with substantial price appreciation potential over the long term. We agree with Buffet's strategy of avoiding one puff investments.

Might we extend this analogy to the stock market: that it has only one puff left? Maybe. We don't know when this bull market will end and don't market time as a matter of a long standing policy, but we do manage portfolio risks prudently by selling overpriced stocks and trimming those that represent an oversized position, among other strategies.

We often mention P/E ratios as a key metric for valuation but there are others–some are described below. However, most come to the same conclusion–stocks are rich. **Historically, valuations alone rarely cause bear markets. There is usually some other factor that acts as the tipping point.** For example, valuations in early 2000 were sky high but the market correctly anticipated a recession coming which acted as the tipping point. What will the next tipping point be?

Here are other valuation metrics we use in addition to the widely used P/E ratio:

- Total U.S. stock market value/GDP (a measure of how stocks are valued in relation to the size of the economy)

Today	140%
2000 Peak	167
2007 Peak	125
2009 Trough	58
Historical Average	63

- 'Cape' Ratio (cyclically adjusted price/earnings ratio)–10-year moving average of earnings adjusted for inflation. Cape is also referred to as the Shiller P/E. It is now at its highest (or richest) level since 1999.
- Price to cash flow–highest since 2002.

- Price to sales–highest since 2001.
- Price to book value–highest since 2001.

The dilemma for stock investors is that times are pretty good but valuations are high. If earnings come through as forecast, stocks could continue to advance. But good times or not, we continue to struggle to find new purchase candidates selling at an attractive price. There are now many one puff investments but few we believe should be held for the long term. Perhaps that's the best metric of all.

Fixed Income Expectations Begin to Change

With absolute Treasury bond yields near the lowest in post-war history and credit spreads among the richest (narrowest) ever, the bond market risk/reward relationship is firmly tilted against investors. Further, the Federal Reserve is now dedicated to raising interest rates while diminishing its balance sheet (QE) and thereby shrinking liquidity (which should pressure both Treasury yields and credit spreads over time).

High-grade corporate debt issuance is setting new records again this year with over $1 trillion already issued. Much of the debt has been used for stock buybacks and dividends which may temporarily support the stock prices but over time increases firm risk. A recent analysis done for the Treasury by market professionals suggested corporate bond spreads could widen by over 1.25% to Treasury debt as the QE unwind occurs. With interest rates this low, there is potential for a significant hit to credit spread products such as corporate bonds.

Further, the Trump administration's growing paralysis and loss of policy momentum in health care and tax reform as well as recent saber rattling with the DPRK may soon alter investor expectations and their willingness to blindly chase yield. This administration, once viewed as a positive force for change, may now be perceived as a liability to markets. In this environment, new and largely untested fixed income ETF products may prove illiquid and difficult to trade should a significant back-up in rates take place.

And as investor complacency gives way to fear, the current low risk, low market volatility environment we have experienced for the past several years (and the 30-odd-year bond market rally) could be replaced by rising rates, more violent price swings and growing potential for significant losses to longer dated and (or) lesser quality bonds. While interest rates will likely rise at a more measured pace, we now believe the popular "risk-on" bond trade will end badly.

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