Market Commentary - April 2017 View this email in your browser

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WEALTH SOLUTIONS

The stock market is discounting rapid earnings growth for 2017 and 2018, which is not impossible but clearly a tall order. After growing earnings by only 3% per year for 2011-2016, S&P 500 earnings are expected to grow 10% this year and 12% next year according to FactSet. Valuations remain rich at almost 18x 2017 forecast earnings for the S&P 500 and hard to justify without corporate tax reductions along with fiscal stimulus. On a more positive note, over the past 80 years the **minimum** blowout in the final two years of a bull market has been 30%. Since "blow-off euphoria" doesn't seem to have taken hold yet the market may still have this to look forward to. Our investment discipline, however, dictates that we continue to be conservative because of the aforementioned valuation levels and the importance of principal preservation for our clients.

Why We Don't Invest in Initial Public Offerings (IPOs)

When SNAP (the parent company of Snap Chat) went public last month, some clients asked if the stock was appropriate for them. We told them no and expressed our concerns about IPOs in general. The offering price of $17 represented 40x 2017 forecast **revenues** (Facebook came public at 10x sales) with no profits expected until 2019 at the earliest. The first trade was at $24 (the price that the retail public could first buy shares). The current price is down about 8% from that first trade level. What will happen to the most exciting IPO since Facebook in 2012 and Twitter in 2013? Probably what happens to the majority of IPOs.

Many investors get excited about the prospect of buying stock in a company that becomes available for the first time on the public market, an IPO. It could be new technology or a new product or service that excites them, but the goal is always the same; make a killing by being one of the first to invest. Unfortunately, most IPOs don't fare particularly well over time

(especially after the first day of trading). Here are three reasons why Clearview does not invest in IPOs for its clients.

1. **<u>We buy shares in companies that are seasoned; those that have proven themselves over time</u>.** We look for a modest debt load and consistent sales and earnings growth over multiple economic cycles. Consistent (and robust) dividend growth is a must for stocks in our Dividend Growth strategy. Most companies we select are number one or two in their industries. These types of companies are also better able to weather a recession because they have experience with them. Most IPOs are untested over a full economic cycle and are far from seasoned.

2. **<u>We abide by strict valuation metrics which usually disqualifies IPOs</u>.** Valuation tools that we use are traditional and very discriminating. For example, price to earnings ratios, price to sales ratios, cash flow multiples, and dividend yields are carefully scrutinized for each new and existing investment. However, IPOs are often priced (valued) as a multiple of sales because there are no current earnings. In fact, profits may not be earned for many years (2019 for SNAP). Although current valuations on IPOs are still very high, they are not as crazy as they were in the 1990s. Some IPO valuations in the dot.com era were partly based on the number of viewers a website received!

3. **<u>The investment track record of IPOs is dismal</u>.** After all, you are buying shares from the "smart money", or those who know the company inside and out. If these insiders are selling, why do others want to be buyers? Of course there have been big IPO winners over time (Microsoft, Google, and Amazon to name a few), but the overall record is inconsistent if not unreliable. For example, the median performance of the 15 biggest IPOs is 4.1% in their first year after the first day's close. A significant number of IPOs lose money for their investors. Facebook was down 50% after six months before it recovered. Three of the "could not miss" IPOs from the dot.com bubble–Pets.com, Webvan, and etoys.com – went bankrupt within two years.

Given these are unproven companies, often at unreasonable valuation levels, it is hard to get excited about investing in IPOs. Instead, disciplined investors should stay true to their methodical analysis and not be seduced by the allure of easy money. There are many successful money management styles practiced by professionals, but very few of these include IPOs as key to their success.

The Impact of Fed Rate Hikes on Households

The recent quarter point increase, one of three rate hikes within the past 16 months, will have ramifications for borrowers, particularly individuals and households. **While we do not see a dramatic near-term rise in rates through this tightening cycle as economic growth and inflation remain tepid, debt holders will find servicing debt more costly.**

Debtors, especially those with floating rate structured borrowing are already feeling the pain. Similarly, credit card interest rates were adjusted upward almost immediately (by day's end on Wednesday, March 15th, the day of the Fed rate hike). "Prime rate" on consumer based bank loans increased within hours as well from 3.75% to 4%.

Rates on new auto loans are expected to rise rapidly as well. Delinquency rates on auto and credit card loans, especially with subprime borrowers, have begun to rise from already elevated levels (at nearly 5% for subprime auto loans and 3% for credit cards). These levels are the highest since 2010 and 2012 respectively and are reflective of mounting stress among borrowers. And while consumer sentiment is on the rise, according to a recent Fed report, banks are tightening underwriting standards on business loans which may impact economic growth over time.

Fixed 30-year mortgage rates, typically priced off 10-year Treasury notes, have risen in unison to around 4.15% from 3.5% last fall. Pressure on Treasury notes has increased since President Trump's surprise election win in November. Further, the unwind of the Fed's Quantitative Easing program (effectively they now own about 20% of the mortgage market) will also place pressure on spreads over the next few years. Rising rates (or mortgage credit spreads as may be the case with the eventual QE unwinds) make housing less affordable and may eventually put pressure on home prices.

One positive for high quality fixed income investors, US Treasury 10-year note yields (at 2.52% in mid-March and 2.40% by month's end) now offer 0.6% more than the S&P 500's collective dividend yield (at 1.9%) for the first time since late 2014. This may help drive demand for bonds. Many investors have yet to benefit from the recent rate normalization however as higher yields on term bank deposits have not yet materialized (less than 0.2% due to a lack of demand for loans).

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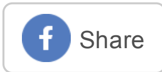

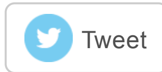

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