Market Commentary - July 2017

CLEARVIEW
WEALTH SOLUTIONS

We issued a special Market Commentary in January 2016 entitled, "China, Oil and the Fed." In our opinion it was these three factors that caused the stock market swoon in early 2016. Our current analysis shows these same three market factors have returned. Could they cause another round of market indigestion? Here were our early 2016 concerns along with brief updates:

- China's economic slowdown was causing a meltdown in commodity prices. Commodities have now resumed their downturn as China has reduced demand for key commodities such as copper, steel, aluminum and coal. In addition, China has seen an enormous growth in debt over the last 15 years.
- Oil peaked at over $100/bbl. in the summer of 2014 and proceeded to plunge to $26/bbl. (WTI) in February, 2016. After rising to $54 earlier this year, it has since dropped 20% and is now in bear market territory once again.
- A Fed governor gave a speech in January 2016 indicating the Fed would likely raise rates four times in 2016, that statement was premature as far as investors were concerned. Last month the Fed announced that four rate hikes should be expected by the end of 2018.

Double-digit earnings growth is forecast for both 2017 and 2018 and will likely drive the market for a while. But the three factors that impacted stocks in early 2016 are back–maybe a warning sign arguing against investor complacency.

More Disruption in Tech Land: Amazon Will Acquire Whole Foods

Since our country was founded, technological innovations have been fast and furious. By its nature, new technology is disruptive (and often deflationary) as it alters business models and most importantly, costs. New tech's impact on costs/revenues can be direct and (or) indirect. And the distinction between deflation and disinflation is important–deflation refers to falling prices while disinflation indicates that prices are rising at a slower rate. The most recent tech cycle began in the '80s and '90s with the increased use of the PC and internet among many other technologies and products we now consider staples in our daily lives (like smartphones).

The breathtaking innovations continue today. A few of the major ones include artificial intelligence, self-driving cars, space flights by private companies, robo advisory investment management (portfolios managed by computer algorithms), and military applications such as enhanced communications, armed drones, and the F-35 fighter jet.

Tech disruption is also showing up in places few anticipated it would. Last month, Whole Foods announced it would be acquired by Amazon (Amazon is really a tech company masquerading as an online retailer). This is a potential game changer in the grocery business. Food prices will likely experience disinflation as a result of Amazon becoming a competitor in the industry. The same disinflationary pressures have been present in other sectors for years (for example, consumer tech products). **No wonder economy-wide inflation is conspicuously absent.**

How does this impact us as investors? In a world where price increases will be difficult to come by for many companies, it makes sense to us to emphasize those firms that have pricing power. This is especially the case in today's low inflation environment. These so called disinflation stocks account for over 40% of our clients' portfolios and include the health care, consumer staples, and utility sectors. Of course we invest in other sectors for diversification, but typically those stocks in other sectors are leaders in their industries with **above average pricing power.** We think this strategy, although not very popular today because of the current emphasis on the reflation trade (Trump stocks), will continue to provide very competitive investment returns for the foreseeable future.

Fed Returns to More Restrictive Monetary Policy

While June's quarter point rate hike grabbed most of the business journal headlines, we believe two other unexpected announcements may have been more important as they clearly indicated monetary policy had reversed course. The unexpected Fed announcements were:

- An intention to hike rates by a quarter point four more times through year-end 2018, and
- The introduction of a policy framework for reducing their $4.5 trillion balance sheet (including Treasury bonds, agency bonds and mortgage backed bond holdings) originally bought to create liquidity (QE).

These announcements unmistakably indicate the Fed will no longer support highly accommodative monetary policy, and this change could soon have an impact on already pricey stock and bond markets.

In a time of persistently anemic inflation and economic growth along with observable commodity deflation financial markets are on a tear. Stocks and corporate bonds have become detached from economic fundamentals as a result of this worldwide central bank balance sheet build (now $19 trillion and counting**). A reversal of this policy could lead to rising volatility and (or) a market decline. Put another way, the rally of the past nine years is now at risk as the Fed's balance sheet liquidity is unwound.**