Insights: December 2017

Market Overview and Performance

Last month we asked hypothetically, “Is this as good as it gets?” Apparently not, because stocks rallied once again in November, pushing the consecutive positive streak out to 13 months. In fact, the S&P 500 has only experienced two down months out of the last 23 according to Morningstar.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
2017	1.9%	4.0%	0.1%	1.0%	1.4%	0.6%	2.1%	0.3%	2.1%	2.3%	3.1%	
2016	-5.0%	0.1%	6.8%	0.4%	1.8%	0.3%	3.7%	0.1%	0.0%	-1.8%	3.7%	2.0%

And with just a few trading days left in 2017, it looks overwhelmingly like December will be an up month as well resulting in the first ever full calendar year with positive returns in every single monthly period. As we have discussed at length this year, the trend upward has been remarkably steady and calm. The S&P 500 pushed through the +20 percent barrier at the end of November, more than twice the average annual return of the last 90 years, yet the largest daily gain was only 1.4 percent notched on March 1st and the worst trading day was on May 17th with a decline of only -1.8 percent. That kind of tranquility is indeed rare and virtually unpredictable given the political acrimony and fruitlessness of the efforts in Washington, the launch of North Korean missiles capable of hitting the U.S., global trade pacts and unions falling apart, numerous natural disasters, greater tensions in the Middle East, a flattening yield curve, Trump administration officials pleading guilty to the FBI and of course a good old fashioned mania brewing in the form of Bitcoin.

Happy Holidays to all of our clients and friends. We wish you the every best in 2018. As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**3.07**	20.49
Russell 2000 Index	2.88	15.11
MSCI EAFE Index	1.05	23.06
MSCI Emerging Markets Index	0.20	**32.26**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.13	3.07
Barclay's U.S. Aggregate Credit Index	0.41	**9.98**
Barclay's U.S. Aggregate Corporate High Yield Index	-0.26	7.18
Barclay's Municipal Bond Index	**-0.54**	**4.36**
Macro Measures		
Gold	0.49	9.79
Crude Oil	**5.26**	6.41
CBOE Volatility Index	9.75	**-24.47**
USD Dollar Index	-1.61	-9.84

Current Theme – Tax Cut Plan Takes Center Stage – Not Clear What the Measure Will Actually Accomplish, but Stocks Use the Excuse to Build on Momentum

Streak of 13 Straight Months of Positive Returns Looks Likely to Extend Through December

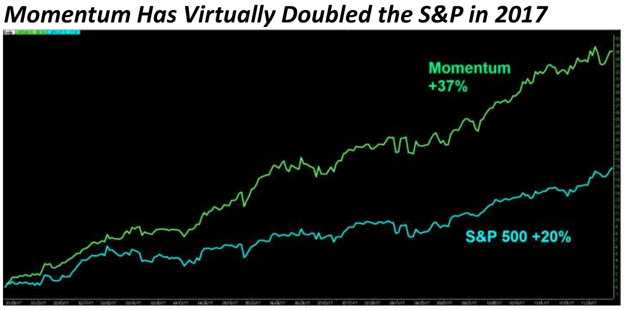
We have talked a great deal this year about valuations, earnings levels, fluctuating market internals, etc., but at the end of the day, the buyers came one after another throughout 2017 resulting in the following.

S&P 500 14 Week Overbought Level Highest Since 1995

Source: Zero Hedge; Societe Generale

With the advantage of 20/20 hindsight, 2017 has been a very easy market to make money in. We are not talking about indexing, we are talking about one factor that has dominated equity performance all year long – momentum.

Momentum Has Virtually Doubled the S&P in 2017

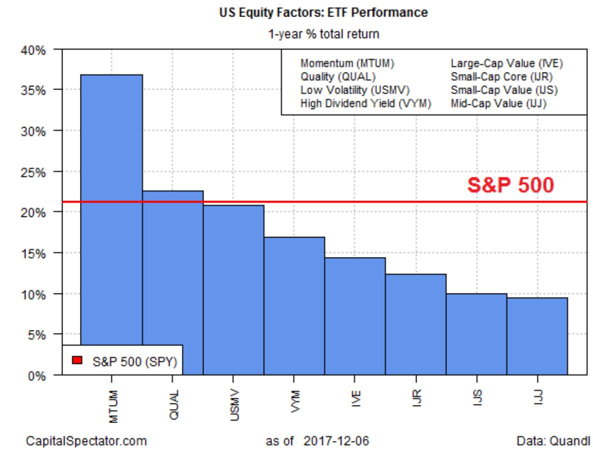


Source: Thomson One

As the name suggests, momentum investing involves simply buying more of the names that are moving higher. As you can see above, one of the investable ways to gain exposure to this factor is the iShares Momentum ETF which has virtually doubled the return of the S&P 500 thus far in 2017.

No other factor has even come close and in fact most have lagged. We gravitate towards quality in our process which leads to a focus on companies with high profitability , stable earnings and strong balance sheets. As a group those kinds of companies have fared well this year mildly outpacing the index, but a broader portfolio with exposure to value and smaller companies would have lagged this year.

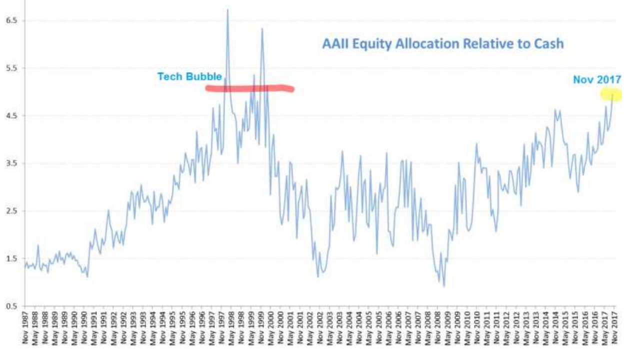
Momentum and Quality Led Performance for the Year



Source: Capital Spectator

However, the most important decision point for the average investor was simply to be in the game. And they are pretty much all in at this point.

Avg. Equity/ Cash Allocation at 5x – Seen at Tech Peak



Source: @TN; American Association of Individual Investors

According to the American Association of Individual Investors, equity allocations relative to cash are back to prior peak levels seen in 2000. Clearly investors don't want to miss out on the seemingly non-stop parade of gains. And it's not just individual investors.

Consider the data below from 361 Capital and JP Morgan. Although the full date range is not specified, JP Morgan claims that virtually all investor groups, including professional and institutional investors, are near the maximum of their equity allocation relative to their historical norm. For example, US households are in the 94th percentile of total equity exposure meaning they have held less stock 94 percent of the time.

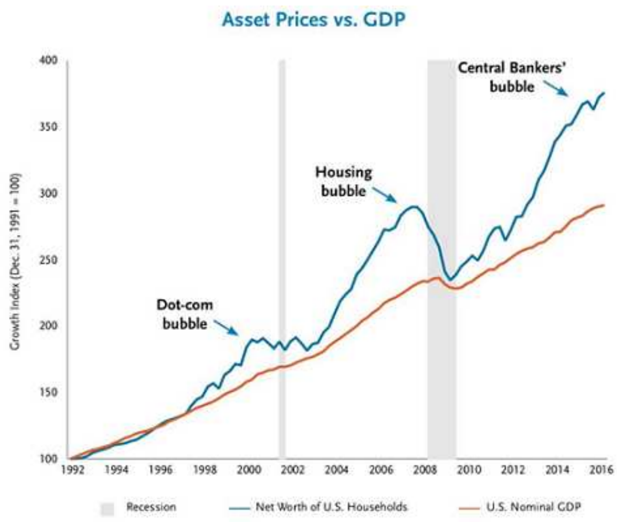
Who Will be the Marginal Buyer of Equities in 2018?

Investor Type	Equity Percentile
Margin Debt/Mkt Cap.	100%
US Households	94%
US Mutual Funds	98%
Pensions	88%
Sov. Wealth Funds	100%
Systematic Strategies	100%
All Hedge Funds	98%
Equity Hedge Funds	93%

Source: 361 Capital; JP Morgan

JP Morgan states that these levels are higher than 2007 and only slightly below those of 2000. This conveniently coincides with the last two times asset prices rose sharply against a backdrop of easing monetary conditions while real growth, or GDP, was more measured. This brings us to the proposed tax plan. Just pump up GDP and it will be fine, right?

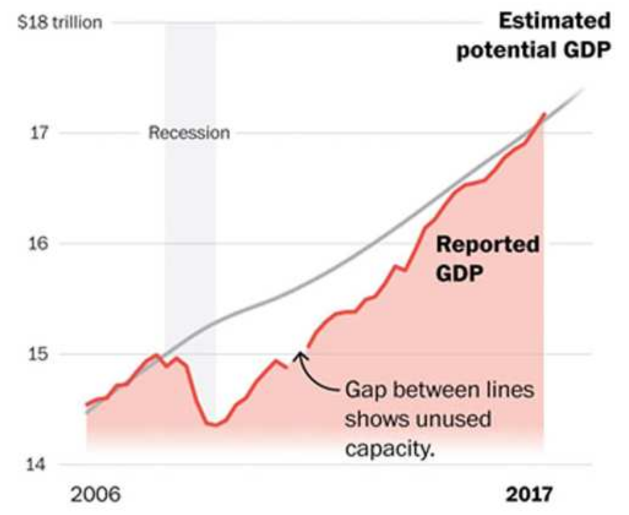
Asset Prices Have Risen Dramatically While GDP Stalls



Source: Bloomberg; TCW; Zero Hedge

Unfortunately, it is not that easy. As of the third quarter, the Commerce Department stated that GDP growth of around 3 percent represents "full potential" economic growth in the U.S.

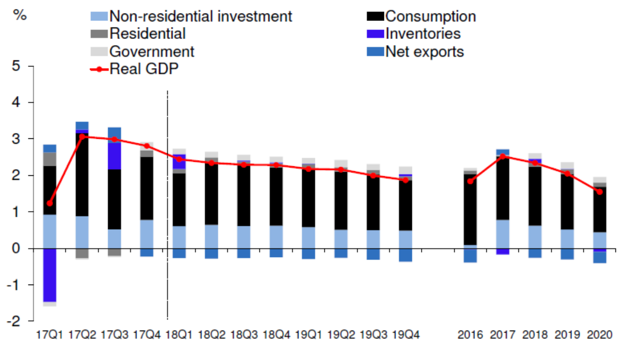
After a Decade Long Lag, GDP is Back to Full Potential



Source: Washington Post; Commerce Dept; Congressional Budget Dept

So where's the problem you might ask? Isn't the tax cut bill going to boost growth? We have some thoughts on the proposal itself, but at a base level, higher growth is essentially mathematically constrained.

Unfortunately, Full Potential Looks to be Just 2-3 Percent

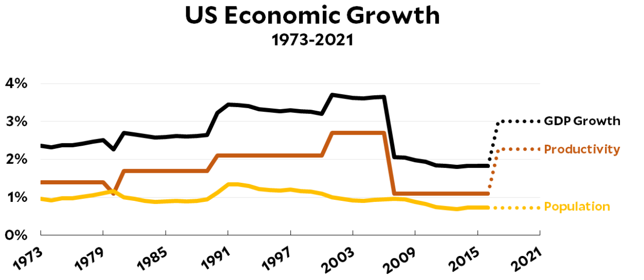


Source: Deutsche Bank; BEA; Haver Analytics; Bloomberg

We selected a chart of GDP projections from Deutsche Bank above to illustrate growth estimates, but we could have shown the same trend from a dozen other sources. Despite what you may read or see on TV or Twitter from certain individuals, GDP growth of "5 or even 6 percent" is just simply not in the realm of possibility. That's because of structural headwinds that are not going away anytime soon.

The two components of economic growth are productivity and population growth. As you can see below, productivity took a severe hit in the Global Financial Crisis and population growth has been in decline for decades.

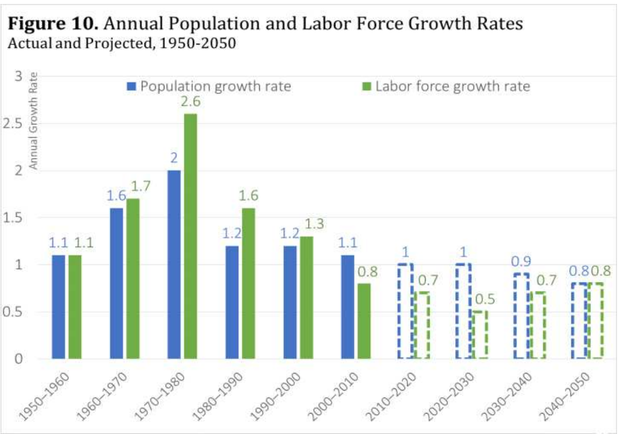
GDP Growth Constrained by Productivity and Population



Source: BLS; Census Bureau

Here are some realties. According to the Bureau of the Census, the "natural increase" is slowing quite dramatically and the main reason the population is growing at all is due to immigration which is estimated to account for what is now 50 percent of growth, to over 80 percent of population growth by 2045. Worse still, even with a population growth rate of less than one percent, the growth in the labor force is even smaller just 0.5 to 0.8 percent, as the chart below highlights.

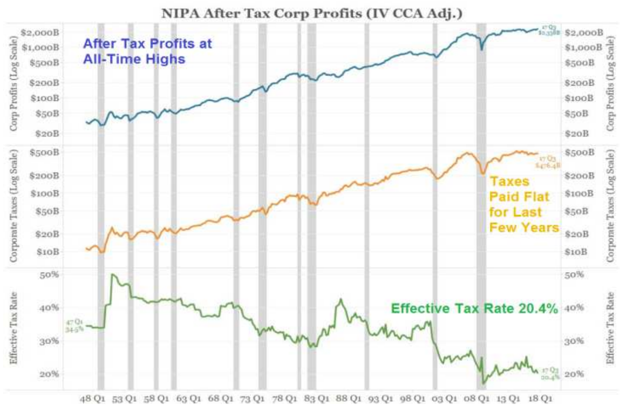
Population Growth in Decline – Labor Population Worse



Source: BLS

There is no fiscal, monetary, or legislative measure that would be able to reverse this trend. Ok then. What about productivity? Surely, this is where the government and tax cuts and whatnot can help, right? The answer is yes, but to a very limited degree. In order to get just 3 percent GDP growth you need to have productivity growth of roughly 2.3 percent. The current growth is less than 1 percent. From 2007 until now, the growth rate has been 1.2 percent and the long term average from 1947 is 2.1 percent. So what can be done? Well, despite the last 70 years of history telling us otherwise, would it be possible to get productivity higher than 2.5 percent or so? What would you do? Well, for starters, you would want companies to invest in the growth of their businesses. At an aggregate level, capex spending growth is very low at around just 1 percent. So the thinking of the tax plan would be to boost corporate profits by reducing corporate taxes. This is a curious idea though since corporate profits are already very healthy.

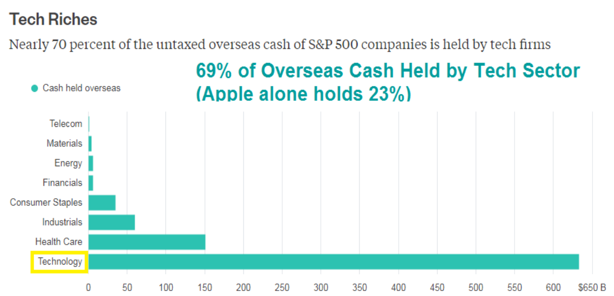
Corp Profits at All-Time Highs, Effective Tax Rate is 20.4%



Source: Commerce Department; Bianco Research; Liz Ann Sonders

Well, alright then. If companies aren't spending a lot of their profits on capex, maybe if we allow then to bring back cash held overseas, it would unleash a wave of investment? Here's the thing - guess who holds most of the overseas cash? It is far and away technology companies.

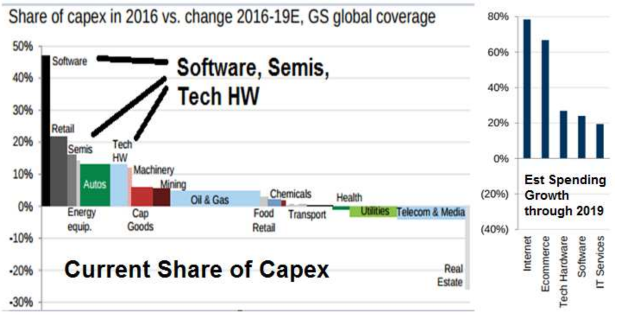
Overseas Cash Overwhelmingly Held by Tech Companies



Source: Goldman Sachs; Bloomberg

And guess who represents the bulk of companies that *actually have* been consistently investing in their own businesses?

Tech Dominates Current and Future Capex Spending



Source: Goldman Sachs Global Investment Research

Technology companies generate a huge of amount of free cash flow that they generally plow back into their businesses already, and plan to continue to do so through 2019 according to current Goldman Sachs estimates. There simply isn't a huge pile of energy or industrial company's' cash waiting on the sidelines. Fine you might say, but if you allow tech to bring back their dollars, won't they use it hire more employees and raise wages? History would suggest otherwise.

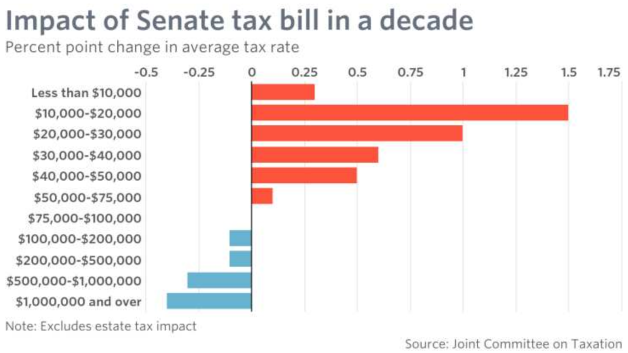
Corporations Have Bought Stock Consistently Since 2009

Source: Thomason Reuter; Credit Suisse; ZeroHedge

Any "extra" cash has consistently bee used to reward shareholders. 2004 provides a concrete example. During that time, Congress enacted the Homeland Investment Act, a one time tax holiday for corporate money repatriated back into the US. They taxed those dollars at 5.25 percent (current proposal is closer to 14 percent.) It worked, luring over $300 billion back into the US. But a 2009 audit of where the money went conducted by the National Bureau of Economic Research suggested that the action "did not lead to an increase in domestic investment or employment." Instead, most of it went into stock buybacks and dividend payments. This is not stimulative. In fact, a 2011 Senate committee review found that the top 15 companies that brought money back actually reduced headcount from 2004 through 2007.

Well, what about individuals you might think, isn't this a middle class tax cut too? Unfortunately, not in any meaningful way. Estimates for an average family savings range from $800 to around $1200. This applies to most people making $100,000 or less, what is generally considered middle class. That's a maximum of around $23 a week. Frankly, that is not a life changing amount. Again, history is a good guide. In 2009, an economic stimulus bill contained a tax break worth around $800 that applied to 95 percent of households. Not a bad thing obviously, but a February 2010 poll found that most people *did not even notice* – only 12 percent said their taxes had been reduced, 53 percent said there had been no change, and *24%* actually thought their taxes had been raised. Even if enacted, families won't see the impact until they file their 2018 taxes in April 2019. Given that and all of the other factors we have highlighted it is no wonder that the current approval rating for the bill is just 29 percent.

By 2027, Anyone Making $75K or Less Will See Tax Raise



Source: Joint Committee on Taxation; Marketwatch

Bubbles…Bubbles…Bubbles…

We think blockchain technology will big a big factor in the future, but if you are curious about Bitcoin, consider the following tale from 5 Minute Finance. (And in case your barista didn't mention it in your last Bitcoin conversation, the total electricity required for the computing power needed for bitcoin mining is currently greater than 150 countries and would surpass the electricity use of the US by 2019 at current rates.)

"Jason and Bourne both run highly successful cafes. And each loves to visit the others. Jason can't go past Bourne's famed avo-smash and Bourne is all over Jason's Mocha-Choco-Lata-yaya. So much so, they are literally in each other's places daily. One day Jason says to Bourne, '*mate, money keeps going back and forth between us, why don't we each just put 100 bucks into a shared account, and rather than me paying you and then you paying me every day, we'll just track who owns what in a spreadsheet*'. Bourne thinks about it for moment, and says '*dude, great idea. But you set it up.* '*Sweet as bro*' replied Jason, '*we'll start it from tomorrow*'.

And so they did. Each put in 100 dollars and each was given 100 'units' in return.

Every day Jason would go home and update his spreadsheet with entries like "Jason owes Bourne 15" and "Bourne owes Jason 11.5" and then send the spreadsheet back to Bourne to confirm. This went on for some time, until their friend Matt the mixologist caught wind and wanted in. Matt said '*my brothers, I want in*'. '*Why*?' asked Jason. '*For the same reason man. You guys are drinking at my bar every day, and I'm eating at yours just as often. It just makes it easier for all of us and means we don't have to keep transferring cash*'. Matt's point was a solid one and so Jason and Bourne brought him in. Matt paid 100 into the kitty and was promptly given 100 units. And over the following months more and more people got involved with the spreadsheet and by the end of the year there was nearly 100 in the system. Each having paid 100 dollars for a 100 units. The spreadsheets were sent around daily to everyone for all to confirm they looked good. Things were working great.

Sadly though over this time, Matt's business had fallen. Distraught, he needed a break and decided to close down his bar. So for him the spreadsheet was of little use anymore. He decided he would cash out. But no one within the system would buy his units from him. This was a problem.

The only way Matt could get money out of the system was when a new person asked to join. So Matt went looking. Actively. And successfully.
And Matt was clever. Rather than selling all his units, he only sold a portion of them, but at a higher price. Matt sold 50 of his units for 100 dollars. And so it began…

Going forward, rather than issue new units to people, everyone using the spreadsheet agreed that for someone new to enter, they would have to buy existing units from someone else in the system.
At first things started slowly. 1 unit cost 2 dollars (rather than 1 when the spreadsheet was first created). But now the existing holders of units realized they could make money by selling their units for a higher price, they started to market their spreadsheet hard. "*The spreadsheet is the greatest thing ever made*". "*It is revolutionary they would say*". "*It makes you run higher and jump faster*". "*Spreadsheets are the new superfood*". They took out full page advertisements in their local paper and radio ads during the 'love hour' evangelising the spreadsheet and the units themselves.

And the marketing worked. People wanted in. And the more people wanted in, the higher the price would go. First to 3 dollars, then 10, then 100! At 100 dollars, one of the national newspapers took notice and wrote an article about a new potential investment opportunity, one which has already gone up by a factor of 100 in just 6 months.
A factor of 100?! In 6 months? Now the speculators got interested. If it can go up 10 times in just six months, imagine what could happen in a year. And so the money flowed in. 200 dollars a unit, 500 dollars a unit. 1000 dollars a unit! Everyone was making money. So copycat spreadsheets started popping up all over the place. The best thing since sliced bread they would say.

Meanwhile, Jason, Bourne and Matt were long gone. They have closed down their shops, sold all their units, bought boats and now just giggle at the price rise."

Going Forward

As we have stated for most of 2017, we are concerned that the combination of overly optimistic sentiment, stretched equity valuations, overbought conditions, international tensions, and Trump's npredictable behavior with both other global leaders and leaders of his own Congress is setting the stage for disappointment further down the road. While neither us or anyone else you might read about can predict the factor that will shift the tide of the markets, we can say that the risks are certainly weighted to the downside as 2018 beckons. As a result, we choose to be nimble at present. We have been fortunate enough to largely participate in the markets' gains this year and have taken some profits at the close of 2017 as a result.

Large Cap U.S. equities have led the market by a wide margin this year and we continue to place our emphasis on this area. Looking forward into 2018, we favor the information technology, financial and energy sectors in particular. The technology sector continues to display very strong growth and profitability. Financial names are still reasonably priced relative to their history and to the market and will benefit from a raising rate environment and a reduction in their tax rates. The energy sector is recovering from what was -20 percent return in the summer of 2017 and the fundamental supply and demand environment has now become a tailwind reinforced by the recent move higher in oil prices.

With the momentum in non-U.S. economies and a trending of a weak dollar this year, domestically focused small and mid cap stocks have been out of favor. With valuations relative to large cap almost exactly in line with historical averages, we would not choose to commit new capital to those segments for the time being, however, changes in the corporate tax policy could quickly change the business environment for many of these companies, a scenario that would cause us to increase exposure to the group.

Equity markets outside of the U.S. are compelling in our view. After years of lagging the U.S. market, International equities now stand to benefit from the following trends: in general, faster economic growth than the U.S., continued quantitative easing, low interest rates, structural reforms, fiscal stimulus, and finally, generally reduced political risks. The relative advantage becomes even more pronounced when one looks at the historical valuation discount. With U.S. equities trading at a cyclical adjusted P/E of over 30 times, future returns are not likely to be as compelling as those potentially found in Europe and Japan. With regard to emerging markets, we also see opportunity. China will always be the wildcard, but as a group they are demonstrating strong profit growth and improved balance sheet stability. While EM equities have experienced solid gains thus far in 2017, valuations still remain very attractive relative to the rest of the world due to the multi-year period of underperformance.

Our biggest concern from the bond market is the continued flattening of the yield curve. Historically, this has been an ominous precursor to economic trouble ahead so we will be monitoring it vigilantly. With a re-ignited anticipation of rising interest rates in 2018, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. Our exposure to municipal bonds has performed nicely in 2017 and we continue to believe that the opportunity in the muni markets is attractive with reasonable valuations and compelling yields.

Amidst a rapidly changing macro environment, Gold has served its purpose this year as a stabilizing diversifier in a time of policy uncertainty. We have also experienced the added benefit of the commodity producing above average absolute returns with gold rising roughly 10 percent. We have maintained a position in many of our portfolios as a non-correlated asset. However, if a more aggressive Fed policy takes hold along with a rising dollar in 2018, the environment for gold would be less appealing.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.