April 14, 2017

Dear Investor,

We are living in interesting times, are we not?!.

Confidence in the economic future has surged in the business community and Consumer Sentiment surveys have jumped notably along with it. In a vacuum, one would think both the business environment and the asset markets are getting ready to rock and roll. Certainly the 'soft data', or sentiment surveys, seem to indicate that is the case. So, '***upward***' climb the markets in anticipation that this soft data will soon turn into hard dollars that spill out of the pockets of happy Consumers and into the cash registers of American businesses! It is a good time to be an equity investor.

By merely looking at the global stock markets, one would think there are no risks anywhere. Not rain nor sleet, nor escalating threats of World War with Russia, Iran and North Korea can prevent global stock markets from rising! Even weakening economic '*hard data'* has no negative effect! Increasing defaults on car loans have no effect! Rising student loan defaults have no effect! A pinched middle class, buried under soaring health care premiums, does not slow down the advance! Even a Washington stalemate, ***the*** key to delivering the policies the markets are supposedly celebrating, has no negative effect!

Importantly, asset markets are ***still*** being boosted by massive central bank interventions (nearly nine years after the great financial crisis). The adage 'Don't Fight the Fed' long ago morphed into 'Don't Fight the Central Banks': the European Central Bank is still conjuring up $60 billion per month and will continue to do so throughout 2017. Much of that newly minted money is finding its way into U.S. assets, including Treasuries and stocks. Central Banks used to only own sovereign debt, but now they buys stocks outright, effectively picking winners and losers. The Bank of Japan (BOJ) currently buys stocks outright, as do the Bank of Switzerland, Bank of Israel and so on. Estimates suggest the BOJ now owns nearly 3% of its stock market with purchases surging 30% last year. It is now top owner of 55 firms![i] At this pace, it will own the entire market in a few years.

In the U.S., the 'buying' is done in a more nuanced fashion: the Fed entices Corporations to issue cheap debt then buy back their own shares, which they did to the tune of more than $450 Billion in 2016.[ii] Goldman Sachs projects a 30% boost to this number in 2017, forecasting that indeed Tax Reform will arrive in the second half of 2017 and companies will embark on a buy-back frenzy to the tune of $780 Billion by year-end. Goldman should know, since their former associates now completely surround President Trump who, despite some entertaining but heavy rhetoric, has done anything but 'Drain the Swamp'. If Goldman is in the building, the swamp is far from drained. ***But*** as far as investors are concerned, if the swamp remains intact, *and* its occupants want the rally party to continue, it very well should. One major caveat to this observation is that Goldman associates seem to enter 'public service' at market tops at times, so they can enjoy some of the perks of transition, then influence policy when things soon go awry. See Hank Paulson, Jon Corzine, etc. We will discuss this further in our ***Behind the Curtain*** section, available upon request.

The key to a continued advance, in our view, remains accommodation by central banks. Add in a twist via Tax Reform and 'Repatriation' of the $2 - $5 Trillion parked overseas, and higher levels may well await. Cautious eyes should follow geopolitical events as they, of course, might be the only thing that could otherwise derail the train. Call us if we can assist you with your allocations!

Best Regards,

Mike Sullivan, President, Certified Planning Professional ®

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Market Update & Backdrop

As just discussed, the Q1 bounce has been largely attributed to 'soft data', or sentiment surveys and the like, anticipation of a rosy future. So far, that has been all the market has demanded. Again, a few big stocks did most of the lifting of the benchmarks, mostly in the technology and defense sectors. As Q2 unfolds, we suspect that decent hard data *and* actual policy progress in Washington will be demanded. For now, we can enjoy the following results and with a wary eye hope they continue:

INDEX	TYPE	Q1 / YTD
Standard & Poor's 500	US Based Large Stocks (500)	**5.1%**
Dow Jones Industrials	US Based Large Stocks (30)	**4.2%**
Nasdaq Composite	US Based Large Stocks	**9.8%**
Standard & Poor's 400	US Based Mid-Cap Stocks (400)	**3.6%**
Russell 2000	US Based Small-Cap Stocks (2000)	**1.8%**
Dow Jones Transports	US Based Transportation Stocks	**1.1%**
Dow Jones Utilities	US Based Utility Stocks	**6.6%**
MSCI EAFE	International Large Cap	**7.3%**
Nikkei 225	Japanese Stocks	**2.7%**
Hang Seng	Chinese Stocks	**9.6%**
Barclay Aggregate Bond	Intermediate Bond	**0.8%**
10 Year Treasuries	Long Term Government Bond	**0.8%**
3 Month Treasuries	Cash Equivalent	**0.3%**

- Rates of return for the quarter ended 3/31/2017. Data from Morningstar, yahoo.com

In Q1, the major strength in the U.S. came from Information Technology as can be seen in the Nasdaq Index performance as listed above. Large companies generally fared better than smaller companies, to some extent due to their expected windfall from forthcoming Infrastructure initiatives and more stock buybacks. While a few stocks did most of the work once again, note that *everything* above in fact landed in positive territory!

Regarding sector performance, Information Technology, Real Estate, Utilities and Consumer Discretionary stocks had strong quarters, the Financials cooled off after a hot Q4 2016, and Energy and Telecom Services provided the drag. Stocks of Utilities companies rebounded as the interest environment relaxed, unlike in Q4 when interest rates surged. Utilities companies, being very capital intensive, are very sensitive to interest rates. Of note, Transports cooled off rising only 1.1%.

It is early in the corporate reporting season as we go to print, so it remains to be seen whether the trend of declining revenues and earnings will be reversed. So far, revenues are expected to be flat again, but earnings are actually expected to grow … for the first time in nine quarters, and at a healthy clip too between 8% and 10%! That would be encouraging, the best growth rate since 2014.

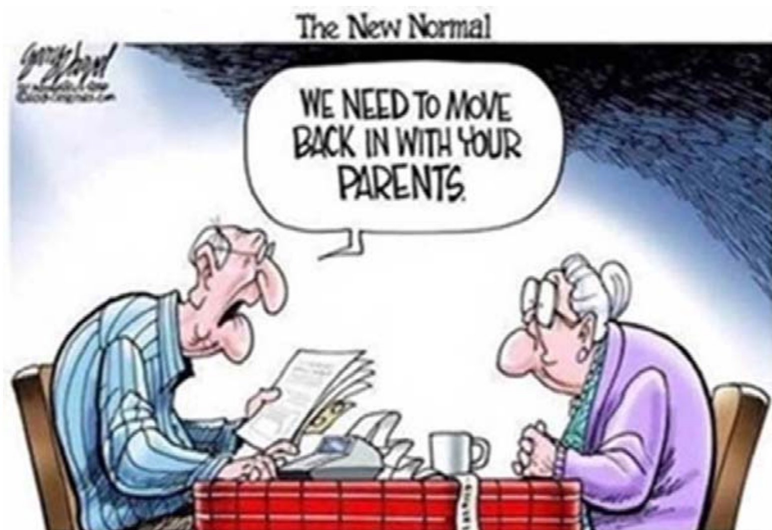
Switching gears to economic data, as previously indicated, the 'hard' economic data has not advanced at nearly the same pace as the forward-looking stock market. At some point soon, one of the two should defer to the other and reverse, then their trend lines should meet once again. Either the economic data improves, or stocks pull back … that's how the process generally works. Here is a look around at where we are presently with regards to the economic hard data[iii].

- The Gross Domestic Product forecast for Q1 per the Atlanta Fed dropped to only 0.9%. Q4 GDP was revised to 2.1% as expected.
- Activity surveys from a number of Fed regions that include Kansas City, Richmond, Chicago and Dallas confirmed economic activity and growth remain. The energy sector is rebounding.

- The NFIB Small Business Optimism Index slid modestly to 104.7 following the health care vote debacle. Plans to increase capital outlays and add jobs both rose.
- Factory Orders grew as expected at a 1.0% clip.
- Construction spending rose 3.0% year over year, up 0.8% from the prior month.
- In the Service sector, the March PMI Non-Manufacturing and Service Indices both cooled off from the February readings, but both remain in 'growth mode'
- In the Manufacturing sector, the March PMI Manufacturing followed suit, cooling off from February but staying in growth mode. The ISM Manufacturing Index, however, rose for the seventh straight month, moving even further into the growth area.
- The Jobs Report missed the mark this month, breaking its recent trend of strength. Only 98,000 jobs were added in March. Importantly, the private sector is adding jobs at a faster pace than we have experienced recently, while the government additions have slowed.
- Mortgage applications dropped -1.6% as housing is slowing down. Much of the housing increase in recent years was driven by Wall Street private equity: the public is *renting*.
- Case Shiller's index of home prices in twenty cities rose 5%. Pending home sales rose 5%.
- Import prices increased 4.2% year over year, Export prices increased 3.6%.
- Earnings for the S&P 500 companies have again gotten off to a respectable start this reporting season (by again beating lowered estimates!). As we go to print, 79 S&P 500 companies have issued negative guidance while 32 have issued positive guidance. The index companies are projected to post growth in earnings of 8.9%, which would be the best growth since Q4 2013 ***and*** break a streak where earnings have ***dropped eight quarters straight.***[iv]

So, all in all the economic data remains decent although it has indeed cooled down over the past month, indicating the stock market may be ahead of itself. In truth, none of the issues we have written about over the past few years have been resolved yet. The data is still very suspect, and the middle class is about as financially repressed as we have seen … tapped out.

The cartoon below and real inflation data from www.chapwoodindex.com tell the story rather well:



For a continued advance in asset prices, the three Critical Success Factors we held out the past few quarters continue to hold serve:

1. Central Banks must continue to mint money and buy stocks – ***they are … mostly***
2. Any 'growth' initiatives by Trump must be funded – ***not yet***
3. The public must continue to be influenced to continue borrowing and buying - ***hmmmm***

Regarding Point 1, while the ECB, BOJ and other central banks continue to prop up stocks and other formerly 'free' markets, the Federal Reserve is actually following through on their promise to raise interest rates. In a recent self-congratulatory victory lap at the University of Michigan, Fed Chair Janet Yellen commented on what a stellar job she and her cohorts at done at manufacturing the weakest recovery in modern history, yet somehow avoided mention of the exploding wealth and income inequality, soaring debt, crushed real incomes, and altered economic formulas used to do it.

Importantly, Yellen has now declared that everything is sound and it is time to raise interest rates. The Fed did in fact hike rates another 0.25% in March, but note that curiously they did so on the back of the Atlanta Fed's weak GDP forecast of 0.9% for Q1. The Fed has not raised rates into such a weak backdrop since 1987. Be very clear it is the unelected Fed, much more so than Washington, that steers the economy and determines our quality of life.

Regarding Point 2, nothing Trump is proposing is paid for … yet. That is nothing unusual as nothing the government does anymore is paid for, but it seems that the Fed is no longer going to 'print and pay' for artificial growth as they did relentlessly over the past eight years. That leaves two remaining sources to fund Trump's policies: 1) natural growth that may emanate from fiscal policies and stimulus programs, and 2) the 'Re-patriation' of the $2 - $5 Trillion in cash sitting overseas. Zero progress is being made in Washington thus far on fiscal policy and stimulus. It seems that the only things our elected representatives actually ***do*** are obstruct each other and run bi-partisan investigations. The 'Re-patriation' effort, however, may offer some real hope though as any deal cut in Washington could result in an instant flood of that money back into the U.S., and probably just as quickly into Congressional campaign funds. Since Congress can profiteer this initiative, it is in our view the most probable outcome, and should be a green-light for a continued stock market rally.

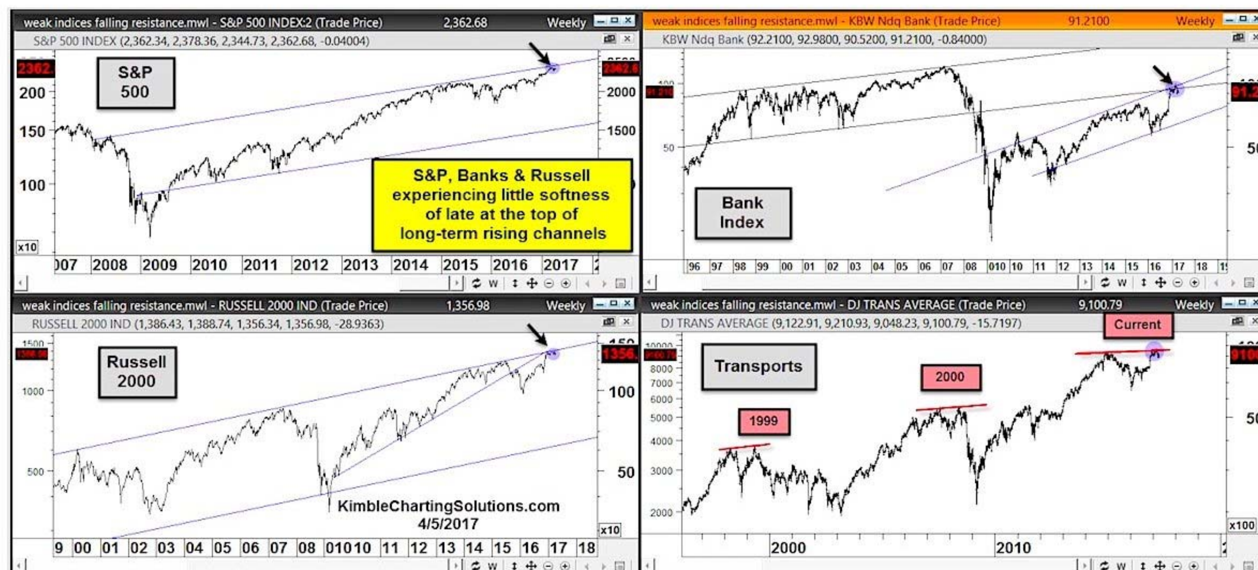
Judging from the rising default rates in sub-prime auto loans and student loans, (something we forecast two years ago), the smoke-and-mirrors pushed by politicians and central bankers seem to be losing their ability to delude people much longer. We have long held out the point that eventually real math would win out and Consumers would not be able to sustain their role of pouring more and more money into corporate cash registers in exchange for fewer and fewer goods and services. All the data-fudging and accounting gimmicks in the world cannot replenish family balance sheets once they have been fully plundered. There are many signs that we have reached that level.

From a market valuation standpoint, an earnings revival would be a strong positive, but there are many indicators that suggest stocks are way ahead of themselves. Perhaps none points that out more so than the one below which tends to mesh well with the weakened state of the family balance sheet just discussed. The chart below plots the number of hours worked at the average wage in the U.S. that it takes to buy just one unit of the S&P 500 … it is nearing its all-time peak, last reached during the insane days preceding the Tech Wreck in 2000:

Source: Zerohedge

The chart seems to suggest there should be at least a pause in the market's advance since it is too expensive for most people, but as is the case with many indicators this ratio may no longer offer as much value anymore since central bank distortions have skewed so many historical correlations. Public participation in the stock markets may no longer be needed much at all since much of the central bank activity goes straight into the hands of a very few, and they drive price. Time will tell.

In the meantime, from a technical standpoint we find ourselves bumping up against trend lines in many different assets and in many different timeframes. Here is a look at a few of them:



Note the S&P 500 and Russell 2000 (large company stocks and small company stocks) are both hitting resistance, as are the big banks whose stocks never fully recovered from the 2008 financial devastation that they themselves foisted on the planet through their greed and corruption. Of more importance, the transportation stocks that largely refused to participate in market rallies over the past few years, then surged after the election, are also bumping up against an important ceiling.

As you can see, there are a lot of pivotal levels in play.

In summary we view the following issues as those investors should have in focus as we roll into Q2:

- Central bank policy matters ***most*** (still).
- '**Re-patriation**' of corporate money sitting overseas likely matters second, like rocket fuel.
- Washington matters less, but it still matters. In light of the Fed hiking rates, a continued log-jam wherein Tax Reform is not delivered may be just the catalyst for a market sell-off.
- Geo-political events are actually boosting markets at the moment as energy prices are rebounding and defense stocks are celebrating, but that could turn if war erupts. The French elections coming up are the next 'Brexit' / Trump type of catalyst for a market move.
- The money-printing continues in Europe and Japan, hence there should be extra support in those regions (with some support in the U.S. since it is currently attracting that money).
- Within the corporate world, we like internet security and a few commodity plays. Uranium is interesting: aside from the fact it has been down six years running, nuclear confrontations may actually give it a boost … one of the few good things we suppose that could come of that.

So, if you have managed to hold some risk exposure through the last few years of central bank magic, the logic still supports that approach. But … keep a wary eye on the list above. If we can help you assess your risk exposure and review your allocations with you, please do not hesitate to call us at (614) 734-9584. In the meantime, enjoy the Spring!

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[i] https://www.bloomberg.com/news/articles/2016-08-14/the-tokyo-whale-s-unstoppable-rise-to-shareholder-no-1-in-japan

[ii] http://www.zerohedge.com/news/2016-12-26/bank-japan-top-buyer-japanese-stocks-2016

[iii] www.bloomberg.com

[iv] https://insight.factset.com/hubfs/Resources/Research%20Desk/Earnings%20Insight/EarningsInsight_040717.pdf