Investment Commentary

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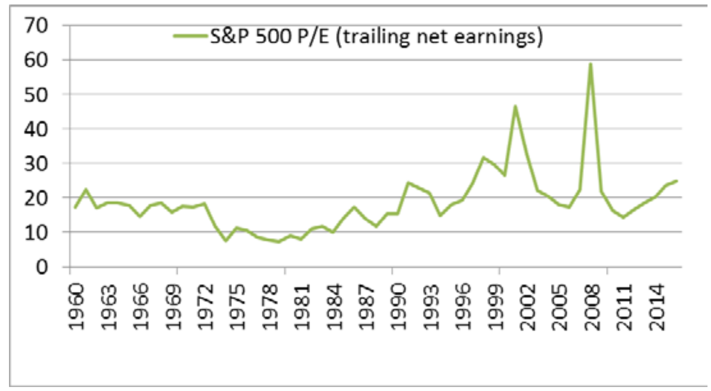
What started off as a difficult year for stocks has turned into an uncomfortable but decent one. Despite an abundance of caution among investors, the stock market as measured by the S&P 500 gained 7.8% by the end of the 3rd quarter of 2016 (September 30, 2016). As an exaggerated example, energy stocks, as measured by the S&P energy sector, were down by more than 14% by January 20th due to fears related to credit defaults and operating challenges. The sector has since rallied nearly 35% as oil prices firmed up -- bringing the overall year-to-date performance to +19.4% for the sector by the end of the 3rd quarter.

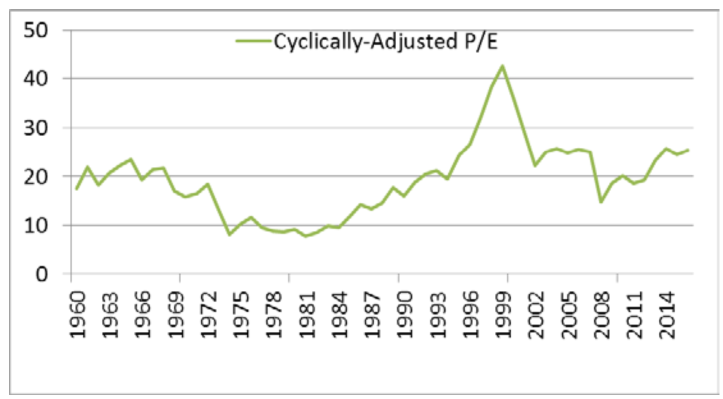
The market finished the 3rd quarter within 1% of all-time highs. However, as companies continue to report on their ability to make money via earnings, the results have been less impressive. In fact, earnings peaked two years ago. Specifically, earnings for the S&P 500 topped out at $106 on a full year net basis in the 3rd quarter of 2014 while that same measure stood at $87 at the end of the 2nd quarter of 2016. Much of this earnings decline has come from energy, mining, and other commodity related businesses that have suffered from an across-the-board decline in commodity prices.

With stock prices near record highs and earnings still a ways from record territory, many valuation measures are starting to push through the upper-end-of-normal. For example, the traditional price-to-earnings measure for the overall market stands at a higher-than-average 25 times.



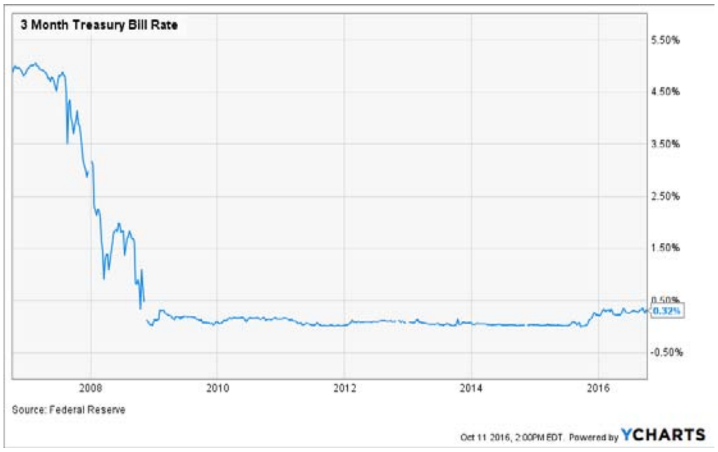
Source: Robert Shiller, Standard & Poor's.

Other measures of valuation also appear a bit rich. For example, the cyclically-adjusted price-to-earnings ratio which averages earnings over the past several years is also historically high.

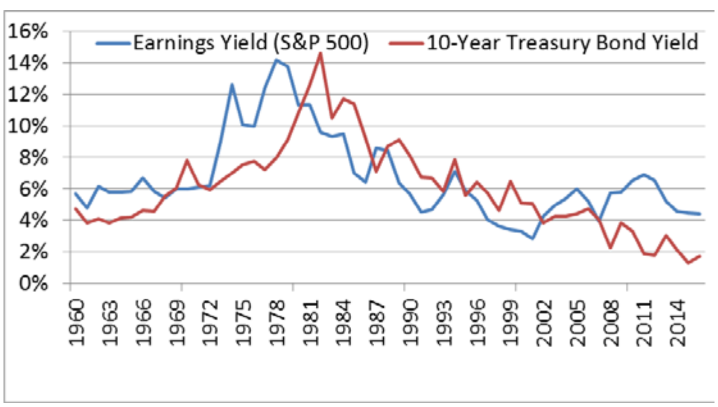


Source: Robert Shiller, Standard & Poor's.

As a result, investors need to consider if the stock market price tag is worth it. Since the two primary choices outside of stocks are fixed-income (i.e. bonds) and cash, we need to consider interest rates. Most of us know money market funds are paying practically 0% interest. As recently as ten years ago, money market rates were over 5% (U.S. 3-month Treasury bill rate is our proxy). If investors were given the choice of similar money market rates today, it is reasonable to assume many would lower their allocation to stocks.



A similar argument can be made for bonds. For this we can compare bond yields to earnings yields; earnings as a percent of prices. When we make this comparison, we are again reminded of the low interest rate environment in which we currently live. Specifically, earnings yields for stocks are significantly higher than 10-year Treasury Bond yields as indicated below; meaning stocks are relatively cheaper than bonds. This is a primary reason why we see several blue chip stocks with higher dividend yields than bonds.



Source: Robert Shiller, Standard & Poor's.

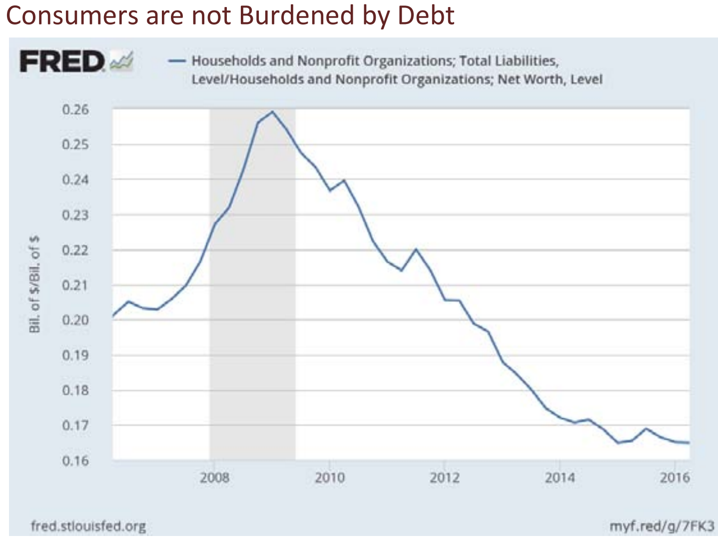
As a result of our low interest rate environment, investors weighing their options often reach the conclusion that stocks are a better deal than money markets and bonds. This does not free investors from the higher risks that typically come from stocks. However, for now, many investors rationally conclude that stocks are a better bargain.

What could derail this line of thinking? Intra-year stock market declines happen regularly to the tune of -14.2% on average according to JPMorgan, Guide to the Markets, 09/30/16. However, these declines are typically short-lived as the market tends to finish the year up 75% of the time, also according to JPMorgan. What is more concerning, of course, is when market corrections last several months or more. This tends to coincide with economic recessions.

The U.S. Economy Remains on Solid Footing

Consumers drive nearly 70% of the economy. Fortunately, the average consumer is benefiting from lower debt levels, higher levels of employment, and higher earnings.

Consumers are not Burdened by Debt



More Paychecks Contribute to Economic Growth

…as do Pay Raises

Outside of consumer spending, we remain broadly favorable on other aspects of economic growth – private investment, government spending, and trade.

Conclusion

In summary, the stock market is becoming richly valued. As with many investors, this grabs our attention. Market values seem to be justified in part by a lack of appealing options via a low interest rate environment. Further, our view is that the next market correction that holds prices down for a meaningful period of time will coincide with an economic recession; outside of extreme action by the Fed or some sort of liquidity crisis of which we see no signs. For now, we appear to be on solid economic footing, and, as a result, remain cautiously optimistic on the stock market.

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