Investment Commentary

April 2017

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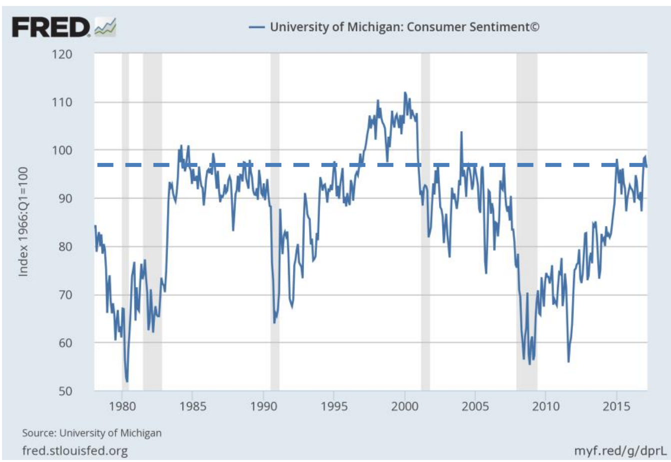
Despite a slower than normal economic recovery over the past eight years, consumers are awash in confidence. This coincides with higher-than-normal investor confidence as evidenced by strong valuations for stocks and bonds.

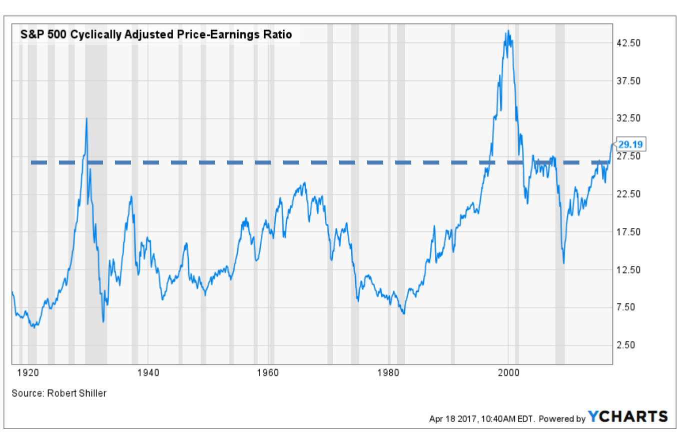
High consumer confidence:



Such lofty sentiment among investors is perhaps the result of the slow-and-steady pace of economic recovery; or the consistent jobs and wage gains; or the continued deleveraging of consumer balance sheets.

Either way, it is times like these when high confidence is at risk of becoming complacency. As a result, continued critical examination of both the economy and the markets are key.

High valuation of stocks:

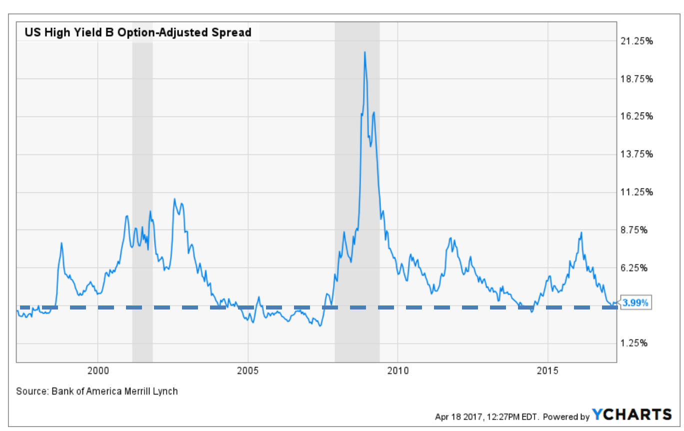


When considering the market's valuation based on its price relative to earnings (in this case earnings are averaged over 10 years), today's valuation is the highest on record outside of the internet bubble of the late 1990's and 1929. Robert Shiller's seminal work on investor behavior won him a Nobel Prize. This chart comes from that effort. In a recent interview (Bloomberg, March 13, 2017), Professor Shiller isn't overly concerned but believes stock prices are too high. He urges investors to "keep funds in the market…just don't go overboard with stocks." We agree. Investors should maintain their long-term strategic asset allocations, and if anything, err on the side of caution.

A similar story can be told with corporate bonds. Corporate bonds have yields higher than risk-free treasury bonds. The difference between the two yields changes over time and tells the story of how confident investors are in taking credit risk. In other words, low relative corporate bond yields indicate investors aren't worried about bond defaults.

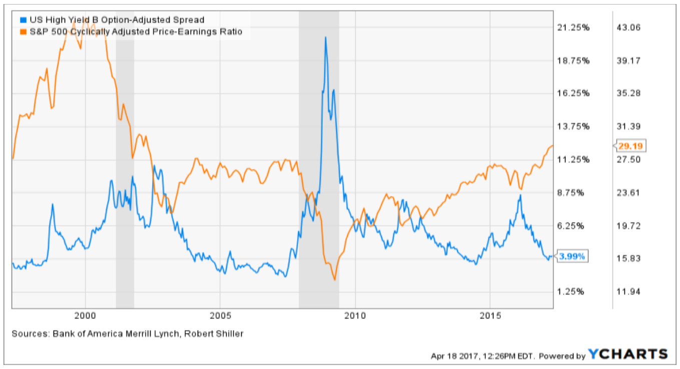
Yield differential between High-Yield Bonds and Treasury Bonds:

Today's low level indicates a lot of confidence in corporate bonds.



Price-to-Earnings Ratio vs. Corporate Bond Yield spreads:

It is also interesting to note that both of these indicators have a strong inverse relationship.



The primary risk is recession:

While valuations are high, they could go higher or remain at elevated levels for many years – reminiscent of the mid-to-late 1990s or the 2004-2007 period. As a result, overly cautious investors face the risk of missing out on healthy market returns. Consider, for example, an environment of strong earnings growth. It would be rare for a significant market pullback during such a period.

Regardless, major market pullbacks happen in and around recessions. So, it is worth taking the pulse of the economy.

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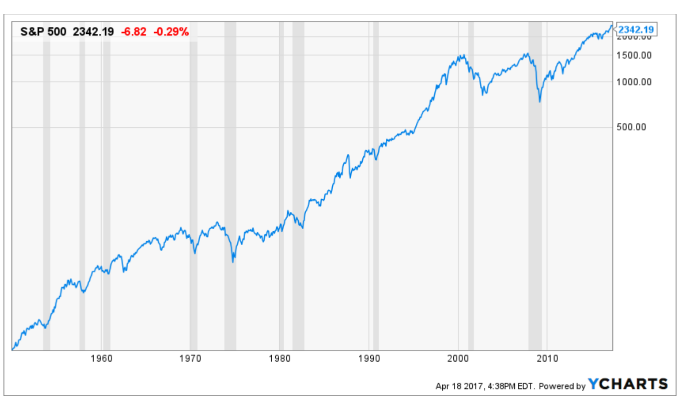
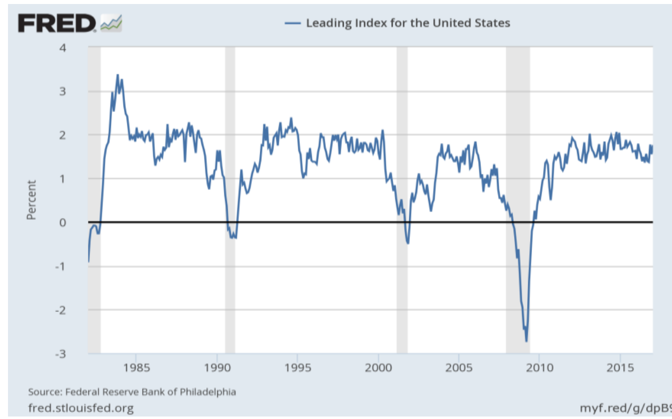


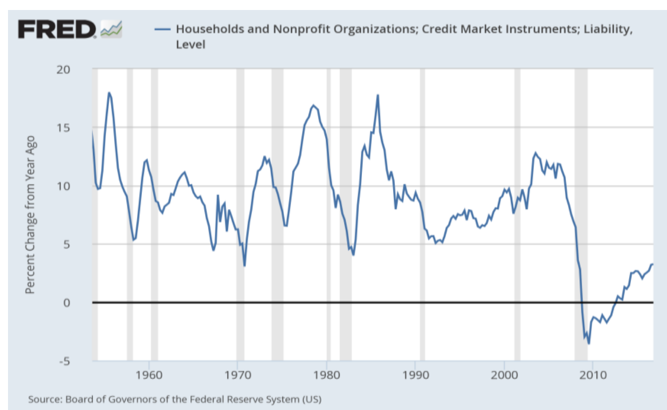
One of our favorite Leading Economic Indicator (LEI) Indexes is strong:

This LEI Index tends to approach zero at the onset of a recession. Currently, there are no signs of a slowdown.



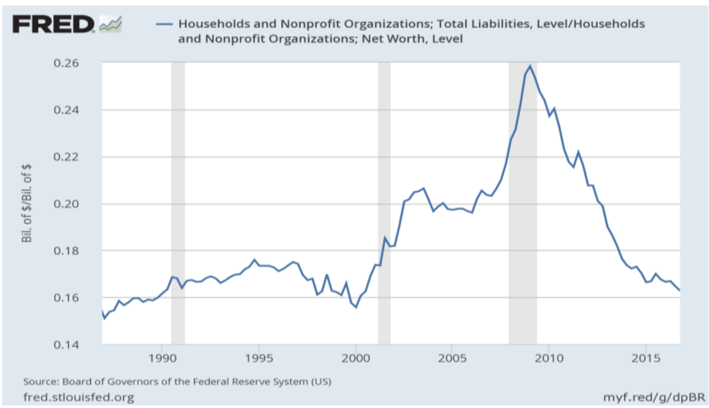
Household loan growth is still below average – leaving plenty of room for growth:

Household loan growth tends to peak prior to recessions. The current level tells us we have quite a bit of room to run before lending peaks.



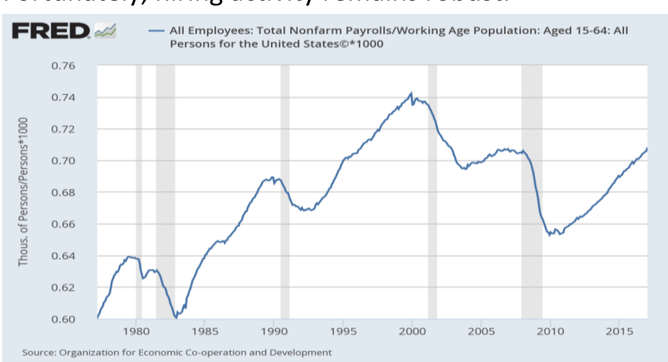
Household debt levels are back to normal:

While household debt levels do not predict recessions, they are helpful in understanding how painful a recession would be. In 2008, household were highly leveraged. When the recession began, they were forced to withhold spending and default on borrowings in a big way – making for a Great Recession.



Job growth continues to climb:

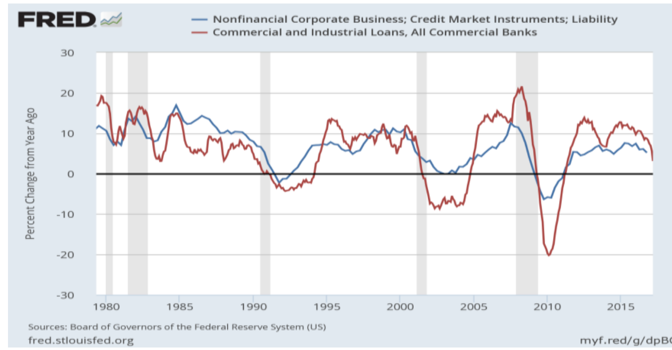
A slowdown in jobs growth often precedes a recession. Fortunately, hiring activity remains robust.



Profit margins remain robust:

Business lending has slowed:

Of the primary indicators we monitor, only business lending is flashing a yellow light. When business lending growth stalls, a recession is possible.



While slowdown in business lending growth is a concern worth monitoring, there is an abundance of evidence that economic growth will continue and possibly accelerate. This is important since high confidence in the markets has led to rich valuations.

We believe there is plenty of evidence that markets will continue to do well (aside from typical pullbacks followed by rapid recoveries) until we are faced with either a rapid pick-up in inflation or an economic recession. Currently, we see neither over the near future.

Regardless, we believe investors should take a close look at their long-term strategic asset allocations and avoid excessive risk taking.

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