Investment Commentary

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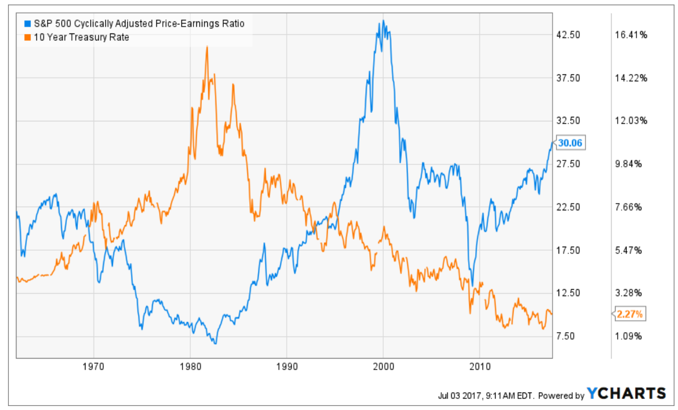
The first half of 2017 has proven to be a solid year for stocks. Despite what seems to be a pick-up in political and geopolitical tensions around the globe, the market's grind northward can be attributed, in our view, to a slow-and-steady eight year economic recovery.

Low Interest Rates and High Stock Prices

A byproduct of the slow-and-steady economic recovery may be record low interest rates. As borrowers and lenders of money reckon with low economic and inflation expectations, it's difficult for lenders to demand high rates of interest to high-quality borrowers such as governments and large-and-strong borrowers. Consequently, yields on many interest-sensitive instruments have fallen to low levels.

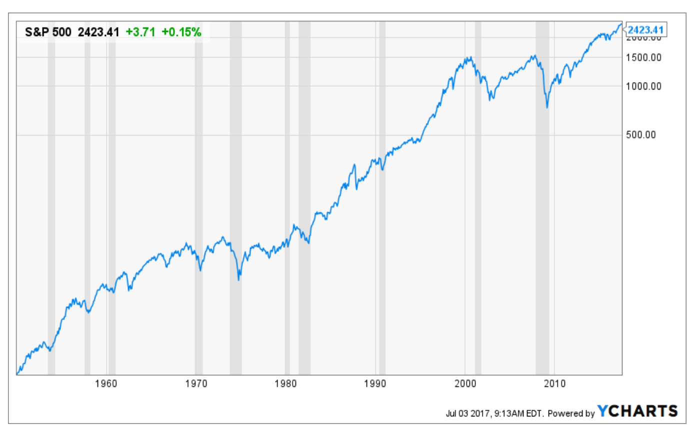
Faced with the prospect of receiving a low rate of return on high-quality bonds, investors are forced to consider other options. Stocks, despite looking expensive on many measures, still offer competitive (or better) levels of income when compared with bonds but also offer the prospect of owning shares in a business that is likely to grow over time. While we are not promoting this line of reasoning, we are reflecting on this pervasive logic that is common in a low interest rate environment.

Either way, we view the low interest rates as a partial justification for high stock prices. If and when interest rates make a significant move up (i.e. greater than 3.5-4.0% on 10-year Treasury Bonds), we believe high stock valuations will be at risk.



Big Stock Market Corrections are Associated with Economic Recessions

While low interest rates offer a reasonable explanation for higher stock prices, a growing economy seems to provide the fuel for continued market gains -- or at least the avoidance of big corrections. The following chart provides a visual of this concept. Notice how longer-term and larger corrections (i.e. greater than 10%) tend to happen primarily in-and-around recessions (the grey bars).



This leads us to the conclusion that taking the pulse of the economy remains quite relevant in understanding the risk of a larger market correction.

How is the Economy Doing?

While not too many people are excited about subpar growth, the economy remains sound on a large majority of measures in our view.

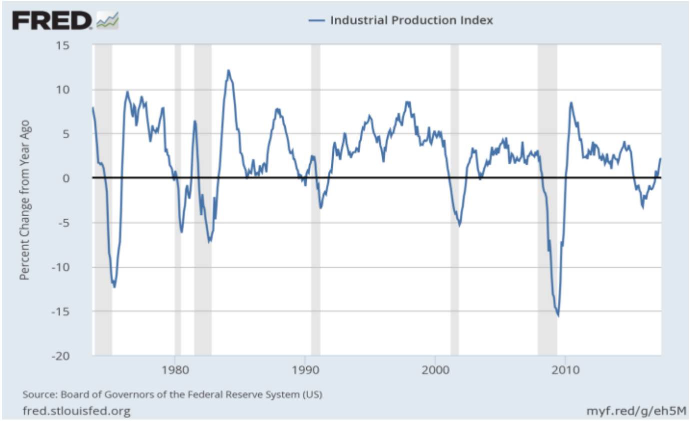
Financial Measure Remain Positive

The yield curve is positive meaning long-term rates are greater than short-term rates. A positive yield curve is healthy for the financial system (i.e. banks) and those borrowers who rely on using short-term financing as it allows them to make money on their long-term investments. The yield curve also happens to be historically predictive of recessions.

Another healthy sign for financial measures in the economy relates to the corporate bond market. Specifically, investors feel quite comfortable lending money to businesses as evidenced by the relatively low "extra" yield received over Treasury Bonds in today's market. A rising spread would indicate corporate bonds are being sold faster than Treasury Bonds and could be interpreted as investors losing confidence in corporations. However, current spreads are at historic lows.

Businesses Seem to be Doing Well

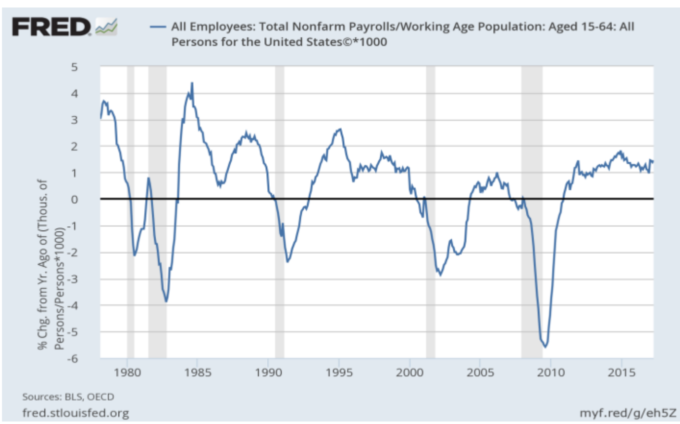
While we could point to many signs of growth in the business part of the economy, it's worth highlighting industrial production which focuses on output by manufacturing, mining, and utilities. At the end of 2015 and the beginning of 2016, growth in industrial production fell below zero. At the time, this was a moderate concern among economists. However, this measure has rebounded to normal levels. Much of the pullback was related to the steep decline in output among energy companies. While this remains somewhat of a risk, we believe its impact is largely contained within the sector.



Consumers Remain on Solid Footing

Consumers drive approximately two-thirds of economic growth. As a group, we spend more when we are gainfully employed and financially flexible (able to borrow money).

Currently, the total number of employees in the U.S. (as a percent of the working age population) remains at healthy levels. Large changes in this statistic tend to be fairly predictive of economic cycles. Currently, it has been holding steady at a healthy level. We view this as a good sign for continued economic growth.

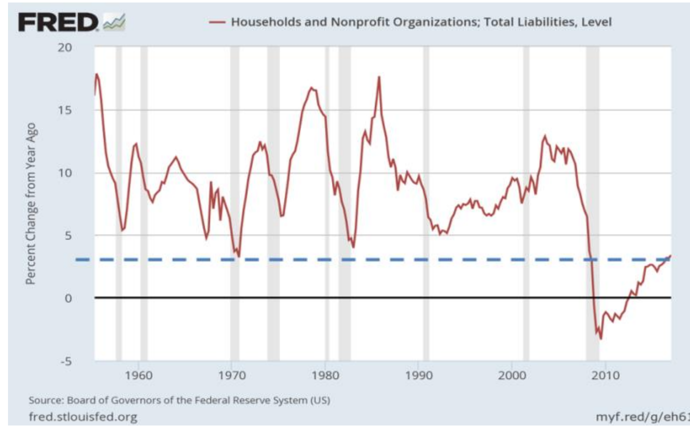


Long Rebound in Consumer Lending

Another interesting component in consumer behavior relates to borrowing money -- mortgages, credit cards, loans, etc. Historically, the borrowing and lending cycle tends to peak well before the onset of a recession. In 2008, the rate of growth of consumer (aka household) liabilities shrunk for the first time in 60 years. Since that time, consumers began borrowing more money. However, the rate of growth has been anemic – still below trough levels seen in every recession since the 1950s.

We view this as positive for two reasons:

1. The rate of growth continues, showing no sign of slowing down;
2. A return to normal levels in the growth rate of consumer liabilities would be consistent with continued economic growth.



Conclusion

The stock market's valuation is significantly higher than normal and is a risk should valuations return to normal levels. We believe higher valuations will continue for two reasons:

1. Investors expect interest rates to remain low as compared to historic levels;
2. Investors expect economic growth to continue.

One of the consequences of slow-and-steady economic growth is low interest rates. As investors weigh the tradeoffs, stocks often are the victor as this helps keep stock prices high.

Continued economic growth, albeit slow, provides the fuel necessary for businesses to grow revenues and earnings. This makes it less likely that a large stock market correction will occur.

Based on our analysis of the economy, we believe economic growth will continue over the next year. However, if and when either of the above two conditions change, it may be time to tactically shift a portion of funds towards less volatile assets.

Regardless, the best defense for riding through storms, real or perceived, is long-term strategic planning. For investors, this means designing an asset allocation that best addresses your needs, goals, and risk tolerances.

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