Investment Commentary

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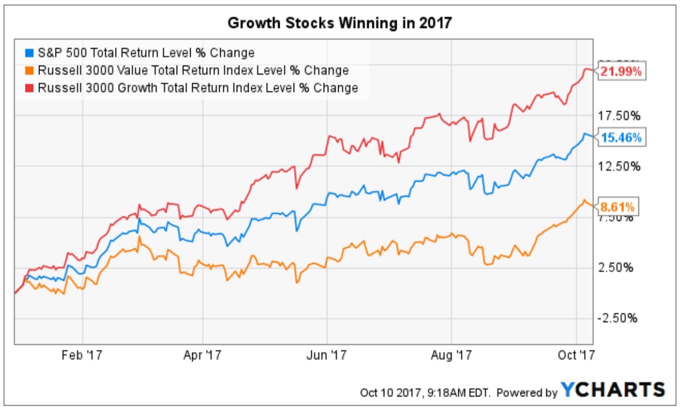
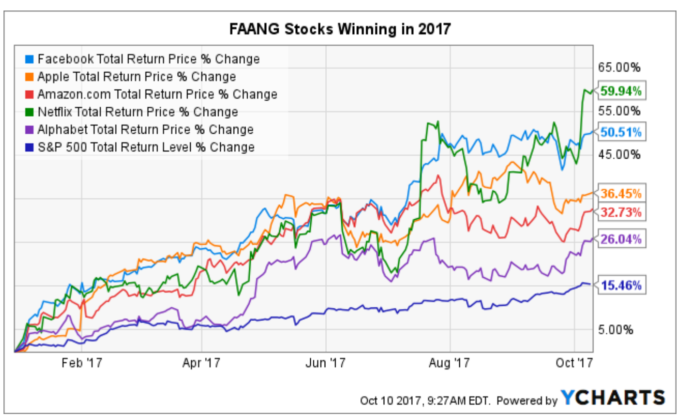
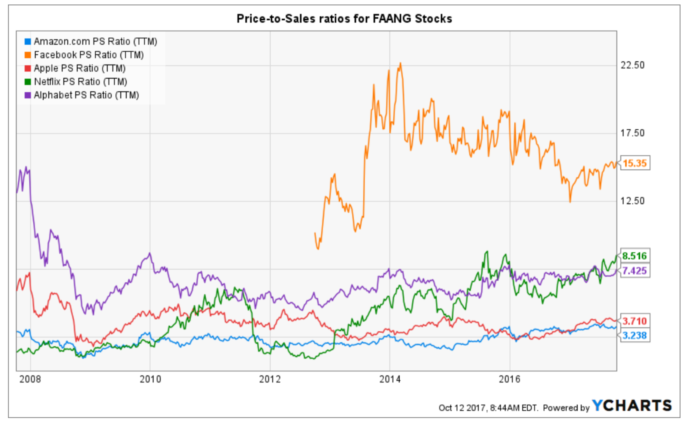
The stock market has continued its ascent in 2017, and companies growing their businesses at a fast clip ("growth" stocks) have led the averages.



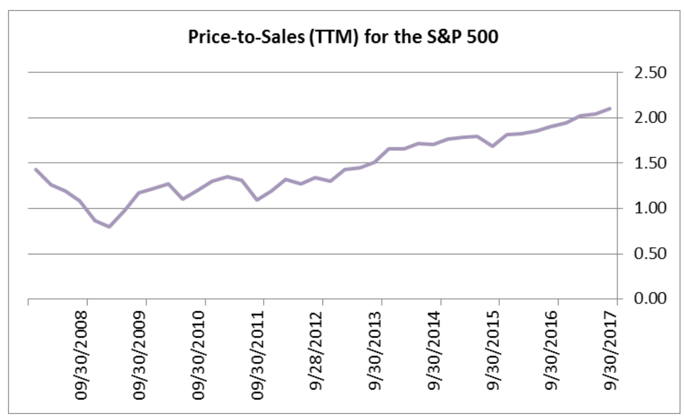
Further, the largest and most dominant businesses within the growth space, the "FANG stocks" (Facebook Inc., Amazon.com, Apple, Netflix, and Google parent Alphabet Inc.), which account for more than 10% of the S&P 500 by size, have dominated the indexes in terms of stock price appreciation in 2017.



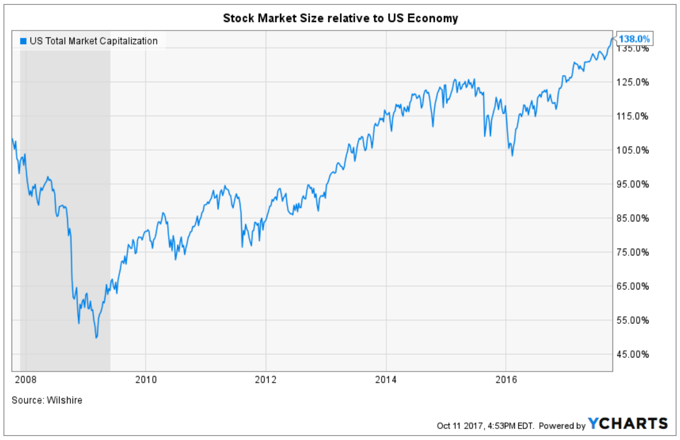
While the performance of these mega-growth stocks may remind some of the last growth bubble from the late 1990s, we do not believe FANG stocks pose a significant market risk. As a group, FANG stocks are arguably over-valued, but certain metrics like price-to-sales ratios have not changed dramatically over the last 10 years. This demonstrates that revenues for these businesses have grown commensurately with their stock prices. In our view, this largely negates the concept of a bubble for FANG stocks.



Taking a look at the broader market, however, we see a different story. The price-to-sales ratio for the broad stock market (as represented by the S&P 500) has climbed strongly over the same period. While we are not suggesting the market is in a bubble state, it is pricey – in our view.



Another way of looking at this is comparing the size of the stock market to the size of the economy. Since 2009, the total value of companies in the market has grown; as has the economy. Below is a chart that provides a ratio of the size of the U.S. stock market to the U.S. economy (Gross Domestic Product - the annual spending – or total value of goods/services provided in the U.S. over a year).



What stands out is that the stock market's size has grown much faster than the economy. Specifically, the market was just over one-half the size of the economy at the bottom of the 2008/2009 recession and is today nearly 1.4x the size of the economy.

In the opinion of many, this helps demonstrate that the market is expensive especially when comparing this statistic to a longer time frame. This viewpoint is strengthened by looking at other measures, such as the price-to-earnings ratios of the stock market, and from a purely historic perspective, we agree.

As discussed in earlier commentaries, much of the market's high valuation can be explained by:

1. A long economic recovery.
2. A build-up in consumer and business confidence.
3. Low interest rates.

These factors remain intact. Consequently, our view remains that the risk of a major stock market sell-off in the near term is low. However, at some point, the market's state of over-valuation will likely be resolved by a combination of business growth (or decline) and valuation adjustments. A reversal in overall business growth would most likely lead to stock price declines. This means the economy is a key to maintaining stock market gains.

As we will discuss below, another consideration that poses a risk to the stock market relates to how the Federal Reserve manages its very large balance sheet.

Therefore, we remain particularly intent keeping a close eye on these two risk factors:

1. The state of the economy.
2. The Federal Reserve's effort at unwinding its balance sheet.

The State of the Economy

After a long continuous string of slow economic growth, we ask what's next: an acceleration or deceleration of growth?

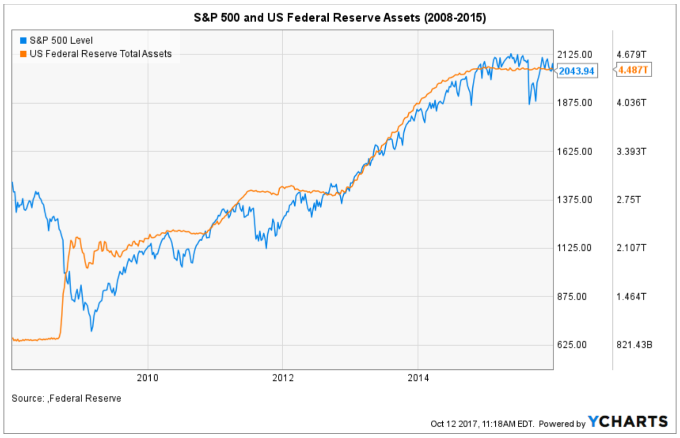
We believe we are more likely to see a strengthening in economic growth due to:

- An improving ability to consume goods and services:
    - Improving wages & low unemployment.
    - Financial strength among consumers and the banking system.

- An improving willingness to consume goods and services:
    - High business and consumer optimism.
    - An improving growth rate in household liabilities from below average towards average.
    - A decline in the personal savings rate.

The Federal Reserve's Effort at Unwinding its Balance Sheet – Reverse Quantitative Easing

For its part in helping the U.S. economy recover from the Great Recession, the Federal Reserve (the "Fed") bought financial assets – a program known as Quantitative Easing. During this build-up of assets, the stock market climbed in a similar fashion. The explanation for this rests on the idea that 1) financial markets (stocks and bonds) are linked, and 2) as the Fed injected more than $3 trillion into the markets, financial assets rose – especially stocks. We broadly agree with this line of thinking.



Recently, the Fed announced it would begin reducing the size of its current $4.5 trillion balance sheet at a rate of up to $50 billion per month. To do this, it will largely let maturing assets (Treasury and Mortgage-back bonds) “roll” off the balance sheet – meaning the Fed will not buy new bonds to replace the maturing ones. Once the balance sheet falls to approximately $3 trillion, the program will be reviewed. One might think of this as “Reverse Quantitative Easing.” In a broad sense, this has the effect of money leaving the markets which, in theory, would exert a degree of downward pressure on financial assets. Since the speed and amount of Reverse Quantitative Easing will be slower than the original buildup of assets, the Fed is creating a longer glide path to achieve balance sheet reduction. Further, the economy is in a stronger position. As a result, we view Reverse Quantitative Easing as a risk worth watching but not likely to derail the bull market at this point.

Summary

Despite richer stock valuations, we see no sign of a bubble – even among the stronger performing sub-group, FANG stocks. Our view is economic growth will likely accelerate supporting continued stock market gains. However, it could also lead to a pick-up in inflation and interest rates from below average to more normal levels.

Although we project continued economic growth, we are keeping a close eye on the ball since an economic slowdown would likely lead to significant market declines.

Finally, we view the Fed’s Reverse Quantitative Easing program to be another risk worth paying attention to. Fortunately, the Fed seems to be taking a slower and somewhat cautious approach to the program.

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