# Investment Commentary

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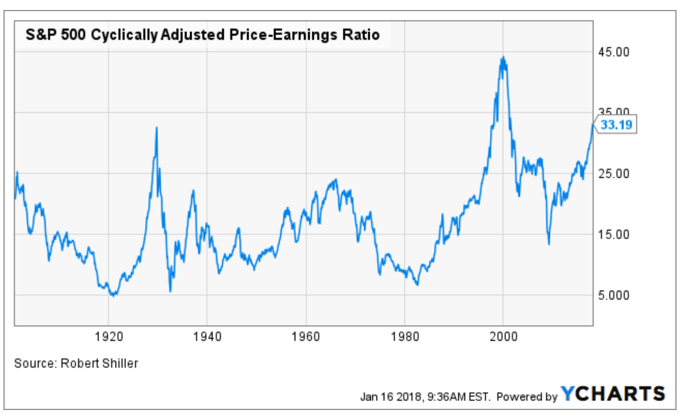
With this report, we take a close look at the risks associated with excessively high stock prices. Though a healthy dose of skepticism is warranted, we ultimately believe a strong and growing economy will preside in 2018 – supporting our base case that the stock market is positioned to have a positive year.

This report is a bit more technical than usual but reveals deeper insight into how we process the current investment climate. What stands out is the degree by which capital markets are linked– stocks to bonds, etc.

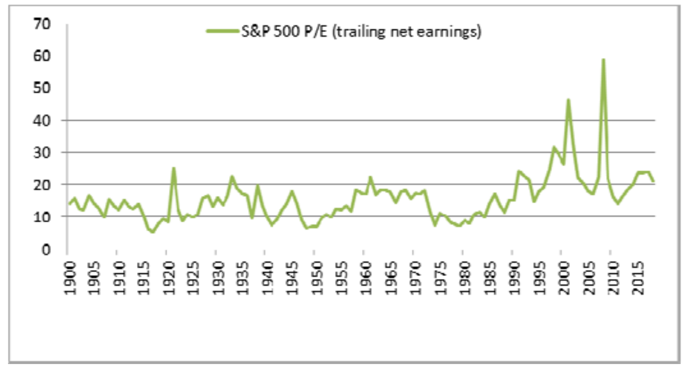
## High Stock Market Valuations

Over the past few years the stock market has marched to valuation levels not often seen. For example, when comparing the market's price to average earnings (the "Cyclically-Adjusted Price-to-Earnings" or "CAPE" ratio), the market resides at levels only surpassed by the later stages of the internet bubble.




Along with other measures that indicate over-valuation of stock prices, like price-to-sales or price-to-book ratios, the market is poised for a reckoning somewhere down the line – either through an extended period of mild returns or through more painful declines.

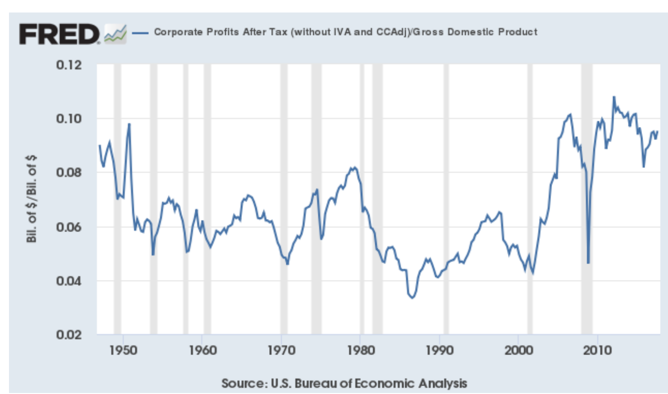
However, there are other measures such as the traditional price-to-earnings ratio for the market (the "P/E ratio") that paint a more reasonable picture. The P/E ratio which compares the index's level (price) versus the trailing 12-months of earnings for the companies in the index may appear elevated but is still arguably within the normal range.




## Four Big Risks to High Stock Market Valuations

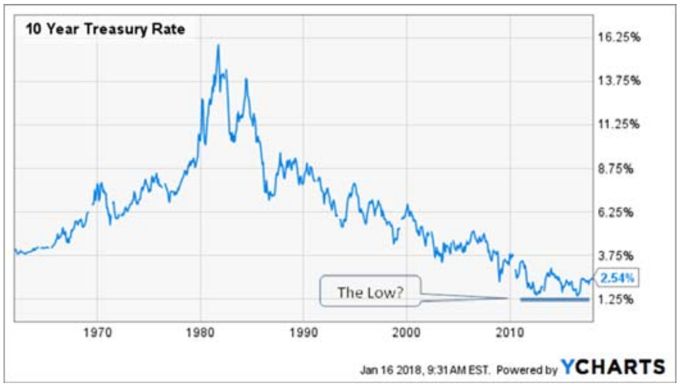
*1) Stock Market Risk: Corporate Profit Margins*

The reason for the difference (a high CAPE ratio of 33x versus a comparatively lower P/E ratio of 20x) can be attributed primarily to historically high corporate profit margins. High profit margins mean earnings have grown faster than corporate revenues. However, if margins decline back to normal levels, the opposite effect would occur with P/E ratios → pushing the P/E up and closer to its CAPE cousin. The result would be an uncomfortably high P/E ratio.




Since today's high profit margins are the exception and not the rule, we view declining margins as one of the primary risks to stock market prices. So, what causes declining margins? The typical factors that attribute to slimmer profit margins are: 1) higher inflation, 2) heavier competition, 3) excessive costs such as debt repayment, and 4) economic recession. While the forth factor, economic recession, is remote, the first 3 factors do pose a moderate risk. However, none seem broad or deep enough to warrant immediate concern. Consequently, we suspect profit margins will remain robust for now.

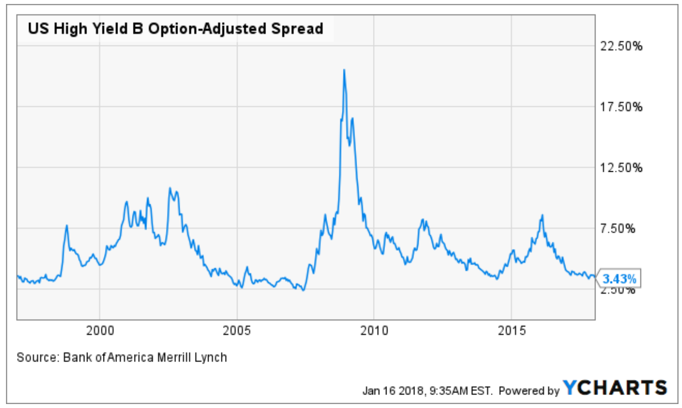
### *2) Stock Market Risk: Rising Interest Rates*




Without getting into a technical discussion about different financial models or discount rates, higher bond yields simply mean investors would, at some point, be lured away from stocks and into bonds with high enough yields – especially if the default risk was little-to-none (i.e. Treasury bonds). Many investors recollect with some nostalgia the high interest rates of the early 1980s – wishing for the opportunity clip coupons at double-digit levels again someday.

For investors to begin in earnest to favor bonds over stocks, we believe 10-year Treasury bond yields would have to climb to a level comparable with earnings yields (earnings as percent of price) on the stock market – currently in the 4.5% to 5% range. In the course of a year or so, bond prices would have to fall substantially for yields to go up to this level. A rapid rise in rates (yields) for Treasury bonds are typically preceded by: 1) rising inflation expectations, 2) an excessive issuance of new bonds, or 3) a significant increase in economic expectations. While we believe all three are on an uptrend, we do not see a full 2% increase in yields for 2018. However, this is more realistic over the next 2 or 3 years if economic and inflation expectations continue to climb.

### *3) Stock Market Risk: Rising Credit Spreads*

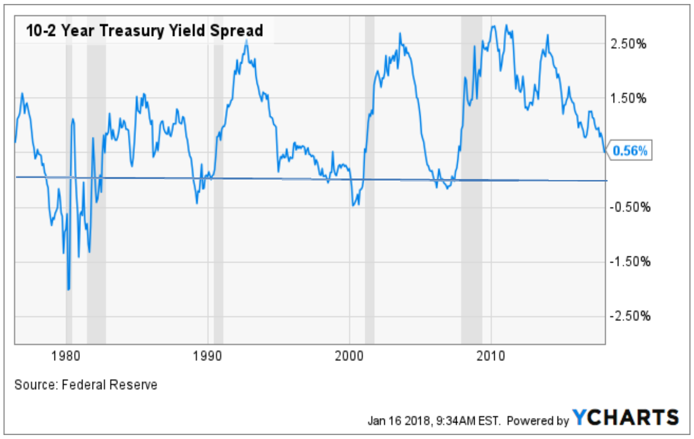



The chart above shows a comparison of corporate bond yields to Treasury bond yields. In this comparison, high-yield corporate bonds produce yields that are 3% to 7% greater than Treasuries. When this comparison (aka the “credit spread”) is low such as today, there is a lot of confidence in the ability of corporations to repay their debt. When the spread goes up, or widens, investors are selling more corporate bonds relative to Treasury bonds; also referred to as a flight to safety. As it logically follows, when the credit spread widens, the stock market typically falls. As a result, the corporate bond market can be very instructive on the risks or reward potential of the stock market. Residing in the lower end of the normal range means confidence needs to remain high for stock prices to continue to climb. Unlike early 2016 when spreads rose due to fears of energy companies going belly up, we do not see any major risks to credit spreads. As a result, we view this risk as low for 2018.

### *4) Stock Market Risk: A Negative Yield Curve*

Finally, the measure that strikes fear into market strategists and economists alike is the yield curve which is simply a comparison of long-term Treasury bond yields to short-term Treasury bond yields. When this relationship is "negative" (aka "negatively-sloped" or "inverted"), long-term yields are lower than short term yields. What is that so bad? More often than not, an economic recession and declining stock market follow a negative yield curve. The reasons for this can be debated, but generally speaking, when short-term rates climb too high relative to long-term rates, the profit potential related to financial leverage declines. Our view is that it essentially becomes too expensive to borrow and make profits for both financial and non-financial sectors.

Today, the yield curve is positive (good), but is trending towards negative (bad). We are not yet concerned though with the prospect of a negative yield curve for two reasons: 1) the Federal Reserve is likely in favor of avoiding a negative curve and will set policy to keep it positive, and 2) the economy likely accelerating which generally is consistent with rising long-term rates.




## Conclusion

We've taken a hard look at the risks associated with high stock market valuations. These risks are real, and we believe there will be a reckoning somewhere down the line. However, our base case is the stock market will end 2018 higher than where it started. The primary reason for this is our view that the economy will continue to strengthen in 2018.

If the economy becomes either too strong or weakens once again, we believe one or more of the four risks outlined above will lead to a correction. Regardless, we do not recommend altering your long-term strategic investment allocation as the stock market tends to grow with the economy over time and plenty of interesting investment opportunities will most likely remain available.

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