Monthly Commentary

September 7, 2016

Party Yet?

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Can you recall a market making new highs and investors feeling like it doesn't seem appropriate? Does that resonate with you? During August, the stock market established several new highs, but ended the month little changed from July. Recall, the market did not achieve a new high in over 280 trading days (almost 1 calendar year) until accomplishing a trifecta in all 3 indexes (S&P, Dow, and Nasdaq) in July; this followed the market providing virtually no return for over 2 years - since June 2014 - stuck in a "go nowhere" trading range. Now, as several new highs are on the books, it seems inappropriate to celebrate, even though we should all be thankful for the progress since February. Yet many market strategists still warn of low returns and years of uncertainty ahead. Other reports indicate wealthy investors are holding record cash out of fear. More broadly, data shows investors continue to pull money from stock mutual funds and ETFs at a record pace, putting the money into low yielding bond funds in pursuit of yield and/or stocks that look like bonds. Does that sound appropriate for a stock market making new highs?

Style	August	YTD
Small-Cap Stocks	+1.4%	+9.7%
Mid-Cap Stocks	+0.6%	+8.9%
Avg US Stock Fund	+0.5%	+6.1%
Foreign Stocks	+0.4%	+1.9%
Large-Cap Stocks	+0.2%	+6.1%
S&P 500	*+0.1%*	*+7.8%*
Barclays Bond Idx	-0.1%	+5.9%

Client Objectives (Stocks/Bonds)	August	YTD
20/80	+0.1%	+3.8%
35/65	+0.2%	+4.0%
50/50	+0.4%	+4.4%
65/35	+0.4%	+4.1%
80/20	+0.3%	+4.6%
95/5	+0.2%	+5.2%

During August, the average US stock fund beat the S&P500 index. Active managers were able to best passive index funds; perhaps that is because it should matter what you own (and/or avoid owning) instead of owning everything, especially when valuations reside near the richer-end of historical experience. Stocks generally beat bonds, unless one owned high yield "bond-like" investments. The yield theme is a key factor so far in 2016, yet this focus is very expensive and thereby exhibits higher risk.

Recent stock market gains may be interpreted to mean US and global economies are starting to show signs of strengthening. Or is that wishful thinking? The stock market is widely viewed as a leading economic indicator. Maybe the corporate earnings recession of the past couple of years (reason for the market being in a "go nowhere" trading range) is ending. Or, perhaps a strong patch for manufacturing and business investment is starting to materialize. Profit recessions can occur without there being an outright economic recession. Yet, the reverse is *not* true – the US economy does not falter (enter a recession) IF profits are rising. Business income is a great indicator of economic health; it is an important barometer of the business cycle. While GDP (gross domestic product) averaged roughly 1% below normal during the past decade, maybe it is starting to slowly improve. If so, the current bull market has room to advance because economic growth would support higher stock prices without additional market P/E expansion (that would be great; the market rising but not getting overvalued). The fact that the profits recession appears to be ending in mid-2016 (and the stock market is starting to rise) is therefore encouraging.

Party yet? It is often said the role of the Federal Reserve is to take away the punch bowl as the party really gets going. For over 7 years, the party has been quite tame, or *(continued on pg 2...)*

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"missing in action". Is it starting to liven up? The Fed is poised to raise interest rates slowly, at any time, again. They raised rates this past December (first in 9 years), but since remain on hold awaiting "better" evidence of economic growth. Maybe their next increase - perhaps viewed as a first increase again - will occur in December following the November elections. While employment stats signify the US economy is at "full employment" and wages are on the rise, US and global inflation remains moderate and flat; there is not enough inflation to scare the Fed. The Fed has twin goals based on employment and inflation. It often appears there is no perfect time to hike rates. That's because there is an asymmetry of risks with monetary policy – tighten (raise rates) too early, and it becomes a policy error; tighten too late and it's usually not a problem. Additionally, the Fed has many tools it can use to tighten monetary conditions, but only a few to ease. Recall last December (at the first increase) the Fed forecast 4 rate hikes in 2016. The pace of rate hikes is progressing much slower because of slow economic conditions in the US and globally. Maybe now, the Fed is starting to see the prospects for improving US and global economic growth, like the stock market. Party yet? Maybe get ready to celebrate. Removing the punchbowl slowly has not historically resulted in the end of a bull market.

Investors and advisors are forced to steer investment assets through troubled market environments – including psychologically troubled investor sentiment. As noted above, the next Fed rate increase may likely be viewed as the first rate increase (again); that may be due to the expectation by some, even many, that the Fed will remain unable to raise rates anytime soon. But what if such skepticism or low expectation is misguided? That's an important idea, since first rate increases often coincide with short-term market decline, typically ranging from -5% to -9%. A market drawdown would lower the current valuation for the market, considered to be full and/or high in some yield-oriented areas, AND provide an opportunity to invest some cash that exists in client accounts. If an economic strong patch that boosts economic growth and corporate earnings is developing, then this 90-month bull market has further to run following a pause that refreshes. In the short run, worries - a Fed rate increase, US presidential election outcome, season of the calendar year, and some others - may create some market volatility. Any of those coupled with small market decline would surely create anxiety for most investors and make deploying cash feel uncomfortable near-term.

In any case, it remains very appropriate for investors to seek opportunities to invest in pursuit of achieving long-term goals. One can say they "know" something, meaning they have understanding of some fact. But, when they say they "know with certainty", that is knowledge proven by understanding and experience. "Time in the market", and resisting the regular urge to abandon long-term plans due to short-term bumps is tested and proven to be THE ingredient for success. "Time in the market" is knowledge with certainty.

"AND THEN THE MARKETS RALLIED TWO HUNDRED POINTS AND THE THREE BEARS FELT LIKE IDIOTS..."

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