CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 3rd Quarter 2017

Summary

The stock rally continued into summer as the S&P 500 tacked on 4.48% in the third quarter.[1] That brings the year-to-date gain to just over 14%. There is an increasing sense of inevitability about the market going up, which on one hand brings more money into the market and on the other hand creates the complacency about risk that usually leads to trouble. Corporate profits were robust during the quarter, so much so that for once analysts were not rushing to lower third and fourth quarter estimates as they have done for at least the past five years. Hopes that corporate tax rates would be lowered helped small cap stocks gain 5.67% last quarter. Smaller companies typically pay much closer to the 35% statutory corporate tax rate than do large companies (which frequently benefit from special loopholes).

Foreign stock markets continue to perform well. Foreign developed markets gained 5.40% last quarter while emerging markets soared 7.89%.[2] The latter were led by the two major Chinese internet stocks, Alibaba and Tencent, each of which rose over 22% during the quarter. Gains were by no means confined to just Asia, however. Latin American stocks jumped close 15.72%.[3] Improving global growth and US dollar weakness were the main drivers. When the dollar is weak, it takes less of the local currency to pay dollar-denominated debt or to buy commodities that are priced in dollars (such as oil). That means there is more local currency in circulation.

Against the backdrop of improving world economies and strong stocks, it is no surprise that bonds gained just 0.85% last quarter.[4] Arguably, that was a fairly strong showing given the change as the markets interest rate outlook shifted from neutral with the Fed on hold to non-neutral with

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[1] Source: Morningstar Adviser Workstation

[2] Developed markets as measured by MSCI EAFE and emerging markets by MSCI EM. Source: Morningstar Adviser Workstation

[3] S&P Latin America 40. Source: S&P Dow Jones Indices Index Dashboard, September 29th, 2017

[4] S&P U.S. Aggregate Bond. Source: S&P Dow Jones Indices Index Dashboard, September 29th, 2017

expectations for the Fed to raise rates. If the economy remains strong enough to justify another Federal Reserve rate hike in December, which markets currently expect, then bonds might post a loss in the fourth quarter. Emerging market debt was the best fixed income sector during the quarter.

A summary of broad market activity is below.[5]

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate		US Bond Market	Global Bond Market ex US
Q3 2017	STOCKS					BONDS	
	4.57%	5.62%	7.89%	1.13%		0.85%	0.70%
Since Jan. 2001							
Avg. Quarterly Return	1.9%	1.6%	3.1%	2.7%		1.2%	1.1%
Best Quarter	16.8% Q2 2009	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009		4.6% Q3 2001	5.5% Q4 2008
Worst Quarter	-22.8% Q4 2008	-21.2% Q4 2008	-27.6% Q4 2008	-36.1% Q4 2008		-3.0% Q4 2016	-3.2% Q2 2015

Activity

We reduced the cash position modestly last quarter. In some cases we swapped more defensive foreign equity funds for alternatives that emphasized cyclical earnings growth over low volatility. We also added a new specialty fund (Versus Real Assets) which provides access to alternative assets such as timberland, infrastructure, and crop/farm land. This should provide a return stream not tied directly to the stock or bond markets. Because we remain in the mid-to-late expansion stage of the economic cycle, we again made no major asset class reallocations. As long as liquidity conditions are favorable, we don't expect to be stock sellers.

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5 Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citi WGBI ex USA 1−30 Years [Hedged to USD]). The S&P data are provided by Standard & Poor's Index Services Group. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2017, all rights reserved. Bloomberg Barclays data provided by Bloomberg. Citi fixed income indices copyright 2017 by Citigroup.

Outlook

Predictions about the future are difficult under any circumstances. Forecasts generally involve assessing where you are currently in the economic cycle, and assuming that over the next several months you will be progressing along that curve. Yet in the current cycle, we have hardly progressed in four years. The US economy was in the mid- to late part of the cycle at the end of 2013 (so we thought), so we assumed 2014 would bring interest rate hikes and an eventual economic slowdown. Instead, we got an economic slowdown with interest rates actually falling to new lows, so essentially the economic cycle slid *backwards*! Since then we have clawed our way back to the same part of the cycle that we thought we were in four years ago. As such, while we believe the Fed will hike rates in December and again in 2018 in response to expected labor tightness and upward pressure on wages, we should not be surprised if that does not happen. Everything about interest rates and the markets since the great financial crisis is unlike anything we have seen before. So far this has been very benign (if not outright fantastic!) for investors. That said, it is anybody's guess how long this benign environment can continue and what happens when it ends.

Commentary – The Next Ten Years (Winter Is Coming)

Ten years ago this October the stock market peaked after a run of about four and a half years. It proceeded to lose more than half its value over the next seventeen months. We remember talking to clients early in 2009 and telling them that we didn't know when the bear market would end or at what price the stock market would bottom, but that we were confident that those investors who could take a ten year perspective would be well rewarded. We knew that the recession would almost certainly be far into the rear view mirror by 2019, so if we could assume corporate earnings would eventually recover then stocks were apt to trade at much higher prices ten years out. In fact, double digit annual returns were very possible.

Eight-and-a-half years into that prediction stocks have done so well that if they did not gain another point in the next seventeen months they will have easily exceeded a 10% annualized return. Unfortunately, what we have to say to investors right now is more or less the *opposite* of what we said in early 2009: *stock returns over the coming ten years are not going to be very rewarding*. Almost certainly, even <u>a six percent annualized return over the next ten years is highly unlikely</u>.

This does not mean stocks should be sold. It just means, to steal a catch phrase, stock market "winter" is coming. What we mean is that you can

think of there being long term cycles in the market where stock prices and interest rates interact. When interest rates are high, typically stocks will trade at lower valuations. The reverse is also true – low interest rates are associated with high stock valuations. During the periods where interest rates are going from high to low, there is an opportunity to earn substantially above average returns. Obviously, even counting the three significant but short bear markets, the 36 year span from the peak of interest rates in 1981 to the present has seen spectacular for investors. The Dow Jones Industrial Average has risen from 900 to just under 23,000, which with dividends included is close to a 12% annualized return! On the other hand, those times when interest rates go from low to high tend to be associated with below average returns. For example, the Dow first approached the 1,000 level in 1966 when inflation was around 3%. As interest rates rose to 14% over the next decade and a half, the Dow tried and failed repeatedly to climb above 1000. It was actually below 800 in August of 1982 when the bear market ended. With dividends included, stocks gained less than 6% annualized from January 1966 to August 1982.

The part that interests us the most is that year-over-year inflation actually peaked in March of 1980 at 14.8%.[6] It took the stock market more than two additional years to convince itself that the inflation era was over. Today inflation is running at less than 2% per year (though it has been increasing modestly). The Federal Reserve has begun to try to "normalize"[7] interest rates, in other words to raise them to a level at or above the rate of inflation. This would mean that savers would no longer be punished (by earning less than 0% after inflation and taxes). We would again expect it to take <u>at least a year</u> after interest rates bottom for investors to begin to believe that the *deflation* era is over. If so, that could create a lot of opportunity for those who can spot this early.

Even if things were to occur just as we have suggested, there is no need to panic. Investors can still do okay in this environment; it just won't offer across-the-board double-digit return opportunity. The 1966 to 1982 market was choppy, but it did not feature the sharp nominal wealth destruction that investors saw in 2000-02 or 2007-09. Only from an inflation-adjusted standpoint would the 1973-74 bear market come close. Also, even if we are entering a higher inflation time period, the amount of debt outstanding should prevent us from getting even halfway to the 1981 peak - interest costs would be too high. More than anything else, we envision an environment evolving in the next few years where there is no

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[6] US Bureau of Labor Statistics, One hundred years of price change: the Consumer Price Index and the American Inflation experience.

[7] Successfully restoring an incentive to save would theoretically lessen economic inequality because lower income savers could once again grow their money without subjecting it to the risk of the stock market. It could also hurt the stock market in that certainly some of the money that is in stocks right now would not be if savers were offered a fair return.

more room for stock Price/Earnings multiples to expand and effectively no benefit for most companies to increase operating leverage. As interest rates rise, profit margins contract. It's a recipe for single-digit returns on average, with occasional bouts of volatility more on the order of what we saw from the summer of 2015 to early 2016.

We believe every investor in their heart of hearts knows this run of double-digit annual returns cannot continue much longer. The economy is not growing at a rate that justifies it, and even the ever-promised corporate tax cut is a one-time change that is arguably somewhat priced in already. We are just confirming what you already know, which is that investment returns going forward are not going to be anywhere near as good as they've been since 2009. Investment winter is coming. Living off one's investment returns is likely to be tougher in the years ahead. Index-oriented strategies may disappoint in that market trends will be more "east-west" than north-south". We have been thinking about what comes after the end of the "Great Deflation" for some time, so we believe we are well prepared to guide you through it.

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