CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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CSFC Financial Market Update

The Federal Reserve raised interest rates by 0.25% last week, bringing the Federal Funds Rate target to 1.00%-1.25%. This was expected, so the impact on stock and bond prices was minimal. The more important news was the weak retail sales and consumer price inflation reports. Those reports suggest that the economy might not be performing as well as stock prices have forecast. This makes stocks increasingly vulnerable to a decline. At the same time, European economies have been performing much better than was expected earlier in the year. As a result, we are seeing fund flows out of U.S. stocks and into international equities (primarily Europe and emerging markets). In addition, those weak economic reports have driven bond yields to a fresh 2017 low. It seems like every year experts predict rising rates (and they certainly did in 2017), but in fact interest rates keep falling. <u>It is this continued decline in interest rates that have supported stock prices over the past several years, not earnings growth</u>. In fact, subtract the effect of stock buybacks on earnings per share and earnings have been fairly flat over the past four years.

For our part, we have continued to maintain an average-to-below average cash position as low interest rates and the spread of the stock rally overseas have given us cause to draw down our cash reserves modestly. This has allowed us to stay rather close to our benchmark returns this quarter and year-to-date. The domestic stock rally so far this year has been led by technology stocks, and while we have exposure in that area, we have not moved to over-weight that sector. Those stocks can be very volatile, and are not priced attractively. Similarly, we have not lengthened bond maturities in order to capitalize on falling interest rates. Global central banks have helped keep bond yields low by buying them in the open market, but we don't believe this is something that can be done indefinitely. We are consciously choosing to be cautious with popular asset classes now as the growth of ETFs and risk parity strategies have the potential to make any downturn sharper. Let us explain.

There is a temptation for investors to fight the last war so to speak, meaning that they become hyper-vigilant for the conditions that lead to the last significant downturn. In this case, they are looking for parallels between today and 2008. Not finding them, they assume they are safe. For our part, the historical downturn that we fear should be more focused on 1987. 1987 saw the market gain over 35% through August before a surge in interest rates led to 30% plunge on October.

Brokerages had sold institutions on a concept called "portfolio insurance", which meant that if stocks prices began to sell off they would sell to protect gains. The problem is that if everybody tries to sell to protect their profits all at once, there is nobody to sell to. Stocks dropped 22.3% on October 19th 1987 fueled largely by automated selling programs. We have gone thirty years without making that particular mistake again. However, today we have 1) the tools (exchange traded funds), 2) the strategies (today it is called "risk parity"[i], which means the less volatile an asset is, the more of it you can put in a portfolio), and 3) the hubris about risk such that a 1987-style elevator shaft decline is probably more likely than any time in the past 30 years. It should be noted the sharp decline in 1987 did not lead to an economic recession, so the market recovered the entire loss within two years. The point we are trying to make is that we believe a "market accident" decline is more likely in the short term than a deep recession decline such as we saw in 2008. Monetary policy is just not restrictive enough to make a conventional interest-rate led downturn likely at this point.

If we are doing our jobs really well, we should have a higher percent of risky assets near market lows that we do at market highs. The trick of course is to get the timing right, as it is very easy to begin selling too soon. We have not begun to scale back yet, but we are seeing things that make us nervous. As always, we try to prioritize capital preservation over growth, and we believe it is foolish to take unnecessary risk just to beat a benchmark rate of return. We are being asked to pay very high prices for bonds and stocks today, but low interest rates and the continued growth of the economy suggest that it is still marginally preferable to do so.

Eric C. Graber, President
952-926-3000

Mark A. Carlton, CFA, Trademark Financial Management
Consultant to Capital Strategies Financial Corporation
952-358-3395

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[i] **The basic concept behind risk-parity it that you have a risk budget and each asset uses up a certain amount of that budget depending on how volatile it is. As volatility falls, you can add more risky assets and as it rises you have to subtract them. It makes sense until you consider that in 2009 stocks had gone through a period of considerable volatility such that their risk budget score would have been north of 20, whereas today it is around 10. So your risk parity portfolio will have a comparatively low amount of stocks at market lows and perhaps twice as much at market peaks.**