CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 4th Quarter 2017

Summary

There is really nothing negative one can say about 2017 in terms of the stock market. Returns were great almost anywhere one invested. A lot of market-friendly events occurred – Emmanuel Macron's victory in France turned the tide against nativism and spurred a 25.32%[1] gain in Europe; China stimulated its economy ahead of the 19th Communist Party Congress, leading to a 41.18%[2] return; and the United States passed a tax reform bill that lowered corporate taxes from 35% to 21%, contributing to a 21.83%[3] gain for the S&P 500. Interest rates remained low enough to support both stock buybacks and takeovers, and perhaps most importantly allowed companies to continue to use debt markets to raise needed cash instead of diluting investors by issuing stock. All of this left most people asking by year end, "How long can this continue"?

For the most part, risk was really rewarded last quarter. Conservative investments made money – they just made a lot less. Utilities gained just 0.2% while Technology rose 9.0%, for example[4]. In an environment where stocks exhibited the least amount of volatility in modern history, investors were emboldened to take on more and more risk. That also played out internationally through emerging markets, which surged 7.44%[5] on the quarter and 37.28% for the year. Energy and telecommunications each managed to post a gain last quarter though both sectors lost money for 2017 as a whole.

Bonds made modest gains in the fourth quarter. The main bond index rose just 0.39%[6] to finish the year with a 3.54% gain. Riskier sectors such as emerging market debt and high yield corporate debt led the way for the full year, but it was more conservative sectors like municipal bonds and inflation protected securities that did the best in the fourth quarter. With interest rates perhaps having made a significant bottom in 2016, there is an increasing belief that the long bond bull market is over. If this is indeed the case, then bond investors need to be more opportunistic now. Using long duration bonds to bet on yield curve flattening was a good strategy until

1 MSCI All Country Europe net return is US dollars, per Morningstar
2 MSCI China all share index net return in US dollars, per Morningstar
3 Standard & Poors 500 Index total return (including dividends) per Morningstar
4 S&P Sector Indices per JPM Guide to the Markets, 4Q2017
5 MSCI Emerging Markets net return in US dollars per Morningstar.
6 BBgBarc US Aggregate Bond Index per Morningstar.

recently. Overweighting foreign bonds to benefit from a falling U.S. dollar is working right now.

Activity

Activity last quarter again centered around reducing the cash position in moderate and conservative portfolios. That said, we did try to find room in larger portfolios for a new fund, the Versus Real Asset Fund (VCRRX). Versus invests in hard assets such as infrastructure, agricultural land, and timber which are difficult to invest in through the mutual fund format. These assets tend to have very much lower volatility owned directly than through stocks, and have lower correlation to the stock market. At some point this bull market is going to end, and we want to own some assets that cannot be dumped wholesale when greed turns to fear.

Outlook

There are echoes of the late 1990s in today's stock market. In those days the narrative was about how technology was going to revolutionize communications and commerce (it did, but that didn't justify paying hundreds of dollars per share for companies with negative cash flow). Today the narrative is about global central banks being run in service to global equity markets such that another -50% plunge in the stock market is unlikely. Again, while there is some truth to this in terms of central bankers trying to be conscious of their effects on markets, at some point the stock market will once again have a significant decline.

Narratives are powerful because they contain elements that are undeniably true as they seek to explain day-to-day investor behavior. A bullish narrative, for example, inhibits selling. Investors both bought and sold stocks in the late 1990s, but what was significant was that they bought a lot more technology stocks than they sold. Today's central bank narrative has prompted investors to sell out of individual stocks and more niche-oriented mutual funds and to buy the stock market as a whole through index funds. The problem is that no narrative can be sustained forever. Eventually economic conditions will deteriorate to the point where central banks cannot (or will not) support very higher stock prices. Thus, investors will definitely participate in the bull market as long as it lasts, but it is also 100% certain they will participate in the subsequent decline.

As far as when that might occur, we are watching interest rates as well as market breadth and a host of other market internals. All of these suggest stocks are likely to go even higher, at least in the short run. We have written on numerous occasions that stocks are expensive, but *valuation does not drive short term performance*. For those of you that are concerned about geo-political events, they rarely drive market performance either. Markets have no good way of discounting the risk of a war with North Korea, for example, so they choose to ignore the situation unless and until it

becomes critical. There is a part of us that really wants to sell and lock in these stock market gains, but we will only do this incrementally unless there is a market or interest rate-based catalyst.

Commentary – Leaning Against the Wind

In a market that seems to do nothing but rise day after day, the question for all money managers becomes how to add value. Other than through the highly risky strategy of leverage, all one can hope to do in a very strong market is to keep up with it. In an asset management program in which the maximum amount of portfolio risk is capped, we will not be able to keep up with an index on an after-fee basis because we can't take more risk than the index. It is tempting in such circumstances to convince oneself that risks are very low. That way, one can justify a higher equity weighting and therefore come closer to index performance. In other words, if stocks exhibit very low volatility over an extended time frame, then they must not be very risky. The problem is that market volatility has over time proven to be mean reverting. Put another way, periods of low volatility ultimately give way to periods of high volatility, and vice versa. Viewing the market with a perspective of years and decades instead of days and weeks, one understands that a prolonged period of abnormally low volatility does not *decrease* your chances of experiencing a sizable loss, in fact it *increases* your chances. From this it follows that a good investment strategy should involve "leaning" against the prevailing sentiment of the time.

Think about the times where market sentiment was the most extreme in either direction. In April 1999 the Dow Jones Industrial Average passed 10,000 for the first time. This wasn't a "sell everything" moment (short of an impending asteroid collision, it is hard to think of what would be), but it was a good time to reflect on the odds of stock prices being much better or much worse two or three years hence since they had trebled over the preceding six years. Stocks would still rally another 15% over the next several months, but a "lean against" strategy of taking some profits would have saved a considerable amount over the next four years. Similarly, the stock market went into a virtual free fall in October 2008 after Lehman Brothers failed. The Dow briefly went under 8,000 on October 10th 2008 before closing at 8,451. With stocks roughly 40% below their peak just one year and one day earlier, it was hard to imagine that the downward trend could still be going two to three years hence. Leaning against the tide at that point admittedly would have been difficult. The market didn't ultimately bottom until the following March (at 6,547), but buying at 8,451 would have looked great just two years later as the Dow rose back above 11,000 (to say nothing about good it looks today)!

The point is, nobody knows how or when the market is going to make a meaningful top or bottom. Investor sentiment is possibly the most reliable indicator that we are approaching an extreme. Greed really seems on the rise today judging by the rapid rise of stock prices, the absence of any even modest correction since Brexit, and the

surge in both crypto-currencies and the stocks of any company claiming to have exposure to them (or to Blockchain, the technology that drives them). It seems to us that right now is a good time to step back and think about how much better things might be two or three years hence relative to how much worse they could be. The stock market is up two-and-a-half times from its October 2011 low; maybe we will eventually get a treble this time as well. The fact is that neither we nor anybody else is going to call the exact top without being extremely lucky, so we have to plan on the most likely scenario which is that we don't meaningfully reduce stock exposure until it is clear that there has been a significant change in market conditions. We can promise you that we won't be the only sellers on that day. If this bull market ends with a long period of sideways action like in the late 1960s, missing the actual "top" won't matter much. On the other hand, the speed at which technology stocks collapsed in 2000 or financials in 2008 was breathtaking.

Economically speaking, America is an eight-cylinder engine hitting on all eight cylinders right now. We're not saying it can't get better, but we are saying it can't get *much* better. Perhaps the current mood of investor enthusiasm for stocks could become even crazier and people might quit their day jobs to trade Bitcoin and Ethereum futures, but in all probability we are a lot closer to the greed end of the sentiment spectrum than the fear end. It's time to plan for the end of this wonderful, powerful bull market. There are a couple of steps we will take when stock market conditions take a turn for the worse; (1) alter asset class weightings (the mix of stocks/bonds/cash) such that a lower percentage of the portfolio is in cash, and (2) exchange into mutual funds and ETFs whose strategies are less volatile than the overall market. That said, we will never move portfolios to 100% cash, no matter the circumstances. We want to work with you to determine how much risk you need to take to meet your goals and how much potential principal volatility you can stomach. Now is the time to have this discussion, not once the decline has begun.

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