

Waiting on a Friend

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The song "Waiting on a Friend" was released by The Rolling Stones in 1981; it is not a song I was familiar with, and not one I'd buy on iTunes. But the title seemed appropriate and fun for this month's investment commentary. It causes creative thoughts to start running. If you were standing on the sidewalk, a policeman might ask you why you are loitering. You might be quick to reply, "I'm waiting on a friend" and hope he accepts your line. Or, if a waiter offered to take your order, your reply could be "I'm waiting on a friend." When investing, "waiting on a friend" could be waiting for the next big up trend in market prices, or looking for a pick-up in economic growth. One could even use "waiting on a friend" relative to active management outperforming passive strategies (more below). Recall that I start this commentary by suggesting that you can develop many thoughts with this title?

Often investing involves identifying the trend, because the "trend is your friend." In today's investment backdrop, we are "waiting on a friend" coming in the form of economic growth. Another axiom "growth solves all problems" is a friend that investors are looking for in the near future. The current outlook calls for improving *nominal growth* – which is supporting corporate earnings – and *remains the bridge in 2017 to get to US government fiscal spending* (which likely takes place in 2018, and will be impactful). Fiscal spending, with a pro-growth and pro-business policy agenda that includes tax reform and regulatory relief, is the "friend investors wait for" to keep the current bull market rising, and running upward.

Growth solves many problems, the most important of which being a valuation issue inherent today in most asset types (most domestic stocks and bonds are not inexpensive). As the Trump administration is learning, not much happens quickly in Washington, even when the majority is from the same party. Fiscal spending was not utilized by the government to spur economic growth for many years. Sequestered spending is waning from being the order of the day since 2013.

The current bull market was born and fueled by monetary policy accommodation beginning in 2009. After the initial application, various Quantitative Easing (QE) activities instituted by the Federal Reserve acted like fertilizer – but with less and less stimulation resulting from each subsequent application (like lawn fertilization, the first application provides the biggest boost). But monetary policy is often not as impactful as fiscal policy (tax reform/cuts, or stimulus spending). Thus, the current economic recovery is considered anemic, slow growth, or running at a nominal 2% rate (when normal was closer to 4%) at best, for much of the last 8 years. If fiscal spending policies are enacted in coming months, their effect will provide a boost in 2018. In the meantime, nominal growth and strong corporate 1Q earnings announcements are providing the "time bridge" until fiscal policy boosts the economy and further increases corporate revenues and profits.

April concluded on a strong note. Client portfolios rose again in the month and added to the YTD performance. Foreign and large domestic stocks were the better portfolio performers. We anticipate 2017 should be an attractive year overall, even if we experience some short-term minor pullbacks following strong performances over the past 12 months. Of course, much of the future performance success is related to our commentary theme, "waiting on a friend."

Style	April	YTD
Foreign Stocks	+2.9%	+11.1%
S&P 500	+1.0%	+7.2%
Large-Cap Stocks	+1.0%	+6.7%
Avg US Stock Fund	+1.0%	+5.9%
Small-Cap Stocks	+0.8%	+2.8%
Barclays Bond Idx	+0.8%	+1.6%
Mid-Cap Stocks	+0.5%	+4.7%

Client Objectives		
(Stocks/Bonds)	April	YTD
20/80	+0.3%	+2.4%
35/65	+0.4%	+3.1%
50/50	+0.6%	+3.7%
65/35	+0.9%	+4.9%
80/20	+1.2%	+5.8%
95/5	+1.4%	+6.9%

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Recent global economic data is on the upswing. Foreign economies are just starting economic rebounds after almost 10 years of no growth; their rebounds can aid global economic growth and continue the US economic expansion. As such, foreign stocks offer better return opportunity than domestic, and are boosting client portfolio performances in 2017 (foreign was more a drag on performance over the past few years). Interesting, as economic growth progresses, it becomes self-reinforcing. Positives are becoming more numerous and stronger, and starting to reinforce one another. And the pace of expansion is starting to spin somewhat faster. Eventually, spinning faster, an economy can overheat. The Fed then tightens aggressively with bond yields rising – sometimes the short maturities will yield more than longer-dated maturities (creating an inverted yield curve). Then, a recession starts. Just the opposite occurs with a recession (not our forecast), wherein negatives reinforce one another as the economy spins down and down. The spinning stops. The recession bottoms; and positives start to develop. Usually as economic growth looks bleak, the Fed eases monetary policy to stimulate the economy. Stimulation can also occur because fiscal policy is initiated in the form of government spending, policy regulations, and/or tax reductions. Today, economic positives are strengthening; AND fiscal spending along with a pro-growth agenda should allow this current bull market to run further.

Understanding the economic cycle provides a helpful reference. The Fed engineered the economic growth of the past 8 years, albeit slow and gradual - below normal. Low interest rates were the trigger, and also altered the investment landscape. Financial assets (stocks & bonds) rose globally because the Fed and other world central banks instituted QE (buying bonds in the markets, propping and boosting up prices) in order to stabilize economic growth. The low interest rates that prevailed were a boon for poorly capitalized businesses, where “anyone who could fog a mirror could get a loan with historically low rates.” Good businesses were challenged to work harder to grow when their competition could stay in business with cheap money. In general, low rates allowed for the misallocation of money (capital). This depressed the rate of economic growth to low levels. Also looking back, low rates were a boon for passive (index) investors while weighing on active managers. Suboptimal, higher risk investment strategies boosted passive (index) returns, while active managers who focused on quality and business viability performed okay, but were not rewarded with superior returns. Over that past 5+ years, money is moving out of active managed mutual funds into passive, index-type funds. From time to time, we receive questions about using more passive strategies in portfolios instead of active managed funds.

It is important to understand that the “low interest rate” environment aided passive strategies during this current 8-year old bull market. Passive strategies, which own “everything” including less attractive companies often beat the “average” active strategies during this time, but generally fall harder when the economic fundamentals deteriorate and business conditions become more challenging. Of course we strive to identify and utilize active managers who are better than the “average”. Still, the question is will this general favor toward indexing continue? The simple answer - probably not; it will cycle around. For me, this type of question existed since the start of money management; I recall its variations over the past 35+ years; it is like comparing Coke and Pepsi; which is better? Is growth style better than value style? Is passive better than active? Nvest Wealth Strategies primarily uses active managed funds with a few passive (index) strategies mixed in. Passive strategies are used when active managed strategies are not performance competitive in a particular area of the investment universe and/or are becoming less tax aware due to negative fund flows (withdrawals from redemptions). Nvest owns active managed funds whose historical performance record is attractive relative to benchmarks and style peers, and we have high conviction in their ability to repeat superior risk-adjusted returns relative to their passive counterparts. Consider a great irony in professional money management, wherein the greatest investor of our generation, Warren Buffett, would undoubtedly have been fired an untold number of times if he plied his trade at a mutual fund or hedge fund company that required that he generate consistently positive returns on a monthly basis. Buffett’s great advantage, of course, is time. When your favorite holding period is forever, it is easier to take advantage of market inefficiencies, which he proves able to identify.

“Waiting on a friend” applies to 2017 company earnings offering a “bridge” before fiscal spending further boosts economic growth and future company earnings. Then, as growth continues and/or improves its pace, “waiting on a friend” is the Fed slowly raising interest rates that rewards investors for selecting better companies (not poorly capitalized, weak business models, or high debt) that can weather the storms of economic cycles; this seems to be underway in early 2017. And, our “waiting friend” is earning attractive returns from active managed funds versus the “own it all” passive strategies. And, when your friend arrives there is usually warm greetings, joy, and good times being together. “Waiting on a friend” is pursuing time as an investor’s greatest ally.

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