# Monthly Commentary

June 5, 2017

## Fundamentals Matter Most

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Political headlines and noise were prevalent during May. All forms of media, the public, and investors in general were totally consumed by Trump's missteps that exploded during the month. The possibility of an impeachment was no longer a trivially small risk, and political gridlock over Trump's agenda was assumed. Since WWII, there were two prior political circuses that consumed the political climate in Washington – the 1972/1975 near impeachment of Richard Nixon and the 1998/1999 impeachment (later found not guilty by the Senate) of Bill Clinton.

The question for investors is whether the sharp increase in political uncertainty really matters for the trajectory of financial assets – bonds via interest rates, currency, commodity prices, and stocks in particular. Even as the popular and business media may be all obsessed by the current stories, there is little historical evidence that these events materially influence capital markets. From 1972 to 1974, the 10-year Treasury yield (often Treasury bond yields are a barometer of current risky moments) was in an uptrend and political uncertainties did *not* trigger a sustained drop for interest rates or stock prices as one might expect. The pattern for the 1998/1999 political crisis was similar. The financial markets moved on; the political noise was just that – distracting noise.

At the end of the day, classic fundamental determinants influencing Treasury yields – inflation, fed policy, government deficit, foreign economic conditions and stock market volatility – appear much more important than shocking political noise in DC. The key question any investor must ask themselves when faced with unforeseen developments is: does this headline or development influence consumer and/or business behavior, and by extension change the dynamics of economic progress? Bottom line: acknowledge the political chatter, but keep your focus on the key fundamental determinants of capital markets' pricing.

US domestic and foreign stocks and bonds climbed in May because of upbeat 1Q corporate earnings and signs of a steadying global economy. US stock indexes posted 8 new highs during the month, bringing the total new highs for the S&P500 to 20, and the total to 35 for the NASDAQ during the 5 months of 2017. Interesting though, the US indexes posted their biggest losses of the year on May 17th after reports allege that President Trump asked former FBI Director Comey to back off an investigation of a former national security advisor and Russian interference with the presidential election. The drop reflected investors' anxiety over the future of the administration's legislative agenda, including tax reform/cuts, deregulation and fiscal stimulus. Market sectors which rallied hard since Election Day and were expected to benefit from Trump's pro-growth, pro-business policies are retreating and hardest hit following these distracting allegations. Nevertheless, domestic stocks advanced with foreign stocks providing a bigger boost to continuing YTD portfolio advances during the month.

| Style | May | YTD |
|---|---|---|
| Foreign Stocks | +3.4% | +14.9% |
| *S&P 500* | *+1.4%* | *+8.7%* |
| Large-Cap Stocks | +1.2% | +8.0% |
| Barclays Bond Idx | +0.8% | +2.4% |
| Avg US Stock Fund | +0.4% | +6.4% |
| Mid-Cap Stocks | -0.3% | +4.4% |
| Small-Cap Stocks | -1.8% | +1.0% |

| Client Objectives (Stocks/Bonds) | May | YTD |
|---|---|---|
| 20/80 | +0.2% | +2.7% |
| 35/65 | +0.2% | +3.3% |
| 50/50 | +0.4% | +4.2% |
| 65/35 | +0.7% | +5.6% |
| 80/20 | +1.3% | +8.3% |
| 95/5 | +1.4% | +8.6% |

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Political research we receive, offers that the Congressional work continues despite lingering "impeachment" noise. One might expect the President's and Congressional agenda might be altered. Rather, just the opposite may occur. Historically the controlling party rallied around accomplishing policy agenda. News headlines will read that political agenda is dead, yet these dire headlines should really serve as a contrarian indicator and motivator to pen accomplishments. We should expect that Republicans (this time around with a majority in the House and Senate) will recognize the game clock is running; there is an expiration date of the next mid-term election to complete work. Republicans must act with intentionality and curb their infighting to fulfill policy agenda, or their opportunity will be stalled via noise and lost altogether at the next election in 2018. If agenda stalls, then pro-growth, pro-business strategies – tax reform, regulation relief, and fiscal stimulus may limit the opportunity for future economic growth, and financial asset valuation will be deemed expensive. Not much policy change is priced into stocks today. Thus, if pro-growth policies are passed (there is very low expectation of such at this time), then domestic stocks could experience a jump in price from current levels.

History reveals that fundamentals ultimately are the key factor driving asset returns. Improving economic growth and minimal inflation pressure is currently supporting risk assets globally. In the US, postponed capital expenditures for plant and equipment (ie: labor saving technology to boost productivity) is helping US economic growth. Add replenishing low inventories and pent-up demand for housing provides an economic floor in domestic growth. Also, US unemployment is very low; finding employees is challenging (unemployment rate dropped to 4.2% and is on pace to achieve 3.5% by the end of 2018); and the average work week is lengthening for workers. Japan's GDP is also solid and growing; the same can be said for Europe, and the world in general shows improving economic conditions. Central bankers, including the Fed, appear willing to "do what it takes" to support economic growth and risk assets. The Fed is likely to raise interest rates in June and maybe September because economic growth is improved. Important too, central bankers are unlikely to tighten financial conditions meaningfully; in fact, many still pursue accommodative, stimulative monetary policies. Thus, it appears that fundamental economic growth is present to support current asset valuations and some continuation of the current bull market. And, IF pro-growth policies are advanced, they would provide a surprise boost to risk assets.

Fundamentals suggest a recession is not in near sight. Consensus thinking expects the next recession is 3 years out. Like in the past, a recession occurs *after* interest yield curves invert (meaning, when short maturity interest rates are higher than long maturity rates). That means that as economic growth and earnings materialize, then stock prices and the current bull market should continue to advance.

For many investors, this bull market was never believed in, and it remains generally unloved. Many still consider it nothing more than a rally; not an 8+ year old bull market. It is also very difficult to find many holding much conviction for further market rise despite improving economic fundamentals. Skepticism seems to be the prevailing attitude of many investor types. Maybe many are too caught with the ongoing instant-media noise that emotional distractions keep clouding required long-term investment principles from working. We must remind ourselves that allowing emotions to influence or make investment decisions, is the greatest hindrance to long-term investment success. In the current negative news-frenzy environment, it is very easy to allow negative emotional feelings alter our expectations for the future direction of stocks and risk assets, and thereby alter long-term plans. We wonder if the intermediate to long-term risks lie with market bears more than with market bulls. Be extremely careful "listening" to emotions. Waiting for perfect is often the enemy of the good.

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