Monthly Commentary

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Risk - Taking the Road Less Traveled

Bill Henderly, CFA, Nvest Wealth Strategies, Inc.

The road less traveled is often a scary road to take. It is not worn in by previous footsteps, and may be cluttered with brush, downed trees and rocks requiring re-direction. Various obstacles may cause one to be delayed as they "clean" a distance of path to move onward; or one may be stuck in a place without help for a while. The route may not be mapped out, so the only thing to go on is your intelligence, your orienteering skills, perseverance, and some luck. Getting lost is very likely. The road less traveled is rich with plunders – like never getting there. But, once you do, it's well worth your trouble. Risk in itself, may be not taking one. Success in life depends on the choices taken (or not taken); the risks you take (or don't take) and receiving a little luck. Life is all about risks and choice– you take some and you avoid others.

Looking forward to the current month, September 2017, it matches up in a similar way to 4 years ago. In September 2013, the financial markets were caught with a number of BIG concerns - risks: Fed withdrawing of monetary stimulus; a possible government shutdown/debt ceiling issue; and the German elections. All weighed on risk assets. As 2013 concluded, the S&P500 returned +13% from September through year-end, as the concerns were alleviated. These same 3 issues again, plus North Korea, face investors in 2017. Often the late summer and early fall are full of worry that can make navigating the investment markets a more challenging seasonal pattern of the year. Since the financial markets are forward looking, the overhang of current issues and weak seasonality is a likely headwind for another 5 weeks or so.

August provided little advance along the investment performance road. For the most part, asset classes and client portfolios moved sideways; they treaded water; they worried about obstacles down the road. Bonds actually provided the best returns compared to stocks; and foreign equities generated slightly better returns than domestic.

Style	August	YTD
Barclays Bond Idx	+0.9%	+3.6%
Foreign Stocks	+0.4%	+19.2%
S&P 500	*+0.3%*	*+11.9%*
Large-Cap Stocks	+0.2%	+11.1%
Avg US Stock Fund	-0.4%	+9.1%
Mid-Cap Stocks	-1.0%	+6.2%
Small-Cap Stocks	-1.6%	+2.6%

Client Objectives (Stocks/Bonds)	August	YTD
20/80	+0.1%	+3.9%
35/65	+0.1%	+4.9%
50/50	-0.0%	+6.1%
65/35	-0.0%	+8.1%
80/20	-0.1%	+10.1%
95/5	+0.0%	+11.7%

The key risks investors and advisors are monitoring include 1) *valuations*, 2) *monetary policy tightening*, and 3) *politics*. *Valuations* are elevated at worst, but more realistically, are fair. Valuations are dependent on economic fundamentals and growth. Currently, the US economy is operating at a steady, solid pace of about 2.5% growth with low, below 2% inflation – this is increasingly being referred to by economists as a "goldilocks" scenario. AND, the global economy is growing at a similar solid pace. Corporate profits are coming in better than anticipated, supporting current market prices. A couple of late-August quotes support the idea that this is the "Best" synchronized global expansion in a decade. At the Fed's international central bankers' retreat in Jackson Hole, Wyoming the IMF said, "We see a really broad-based global recovery in a way that hasn't been in a decade." And the Wall Street Journal reported, "For the first time in a decade, the world's economies are growing in sync as a result of stimulus from central banks and gradual fading of crises. All 45 countries tracked by OECD are on track to grow, and 33 are poised to accelerate." With the US dollar down almost 10% from its recent peak, it provides a further important lift for US growth, commodity prices and S&P earnings. Additionally IF, US fiscal policy changes occur, infrastructure spending and tax reform, additional economic boost would likely push domestic economic growth toward 3% (normal). This key fundamental backdrop – synchronized global expansion - supports the prospect for future gains continuing.

nvest
WEALTH STRATEGIES
Delivering financial peace of mind.

CONTACT US:

10268 Sawmill Parkway
Powell, Ohio 43065
614.389.4646

WWW.NVESTWEALTH.COM

Second, *monetary policy tightening* poses a risk. The Fed is now raising interest rates and will probably soon start to shrink its balance sheet which grew as a result of numerous QE actions over 7 years following the financial crisis. At the same time, it is believed the ECB may begin to tighten in 2018. The worry is about changing monetary policy, from easy to tighter too quickly or too much, that the pace of economic growth that finally is synchronized will stall. For the time being, interest rates are still historically low - lower than normal for 3 reasons: 1) easy global money policies; 2) inflation is generally MIA; and 3) moderate global growth. All 3 ideas support the perspective that policymakers should "go easy" toward tightening monetary policy (raising interest rates and running off QE balance sheet growth as bonds mature). Further, looking at the US yield curve – one can observe that yields of most every type imply the Fed is, more or less, done tightening. Maybe one more hike in the next 12 months. The bond market needs to see inflation or a spark that will prompt inflation to pick-up, in order to see a material rise in yields. Without such, the Fed and other global central bankers should be cautious and slow implementing tighter policies that could slow economic growth.

Third, *politics* is a mess. Washington is a mess, and poorly respected. Uncertainties surrounding President Trump and the geopolitical trouble spots create a lot of distraction. Since the November elections, the financial markets journeyed the road less traveled, providing unexpected positive results. Did you know… every publicly traded company is required to identify and discuss risks to their business as part of their 10-K filing (started in 2005)? It is notable that government and political risk is gaining increased mention in these company risk discussions by management. In fact, 63% of companies cited the government as their highest risk or a growing risk since 2008. The number of words used to review government risk increased nearly 7-fold from 2005 to 2016, and it is an increasingly larger portion of their risk profile. You might guess which industries devote more language to government risk – health care, energy, industrials, financials, and telecom; the least is technology. But that seems likely to rise as the government deals with automation and consumer data issues. Likely too, most every citizen feels government is a mess, and regulations are too costly in our daily lives.

So, will the end of this Bull market be different this time? At 102 months old (since March 2009), its duration is longer than the average, yet it is not the longest which ran 120 months (1990 to 2000, with the tech bubble). Previous Bull markets ended after significant policy interest rate hikes and yield curve inversion (short rates higher than long rates). And, higher rates were generally pursued because the economy was strong and inflation was quickly rising. Today, bond (credit) markets remain calm – spreads of lower quality bonds are staying low. The word "spread" is used to denote the interest rate pickup one receives by owning corporate, or lower quality (higher yield) corporate bonds instead of US Treasury (high quality) government bonds. Spreads of lower quality, more risky bonds, tend to rise early when risk is perceived to be increasing, or economic conditions are deteriorating (because softer economic conditions will make it more difficult to pay interest on large amounts of debt). Both high yield (lower quality) and other corporate bond spreads are lower today than at the start of the year. That suggests the bond market does not yet perceive the underlying economic fundamentals are changing in an adverse way.

Hopefully, this commentary is not too technical. Hopefully, it is helpful to your understanding of investing for the long term. We are watchful and mindful of the landscape surrounding the road the markets are traveling. As the economic fundamentals remain our key focal point, investors should maintain the view that other distractors will always exist, just as they always did.

How amazing it would be, how difficult it is to understand… Australia's economy is without a recession in 26 years! If the US expansion were to match that economic feat, economic growth would continue into 2035. Doubtful; uncertain?! A continuation of slow growth would support a low return market experience. If the global economy is synchronized toward improving growth, then this Bull market can add age to its resume. Australia is proof positive that economic cycles need not die because of age alone. This Bull market is certainly unloved and investors' lack confidence in its resiliency. The road less traveled is often scary. British inventor James Dyson spent 15 years making 5,126 prototypes of a revolutionary kind of vacuum cleaner, all of them failures. The 5,127th version was a success. In almost any case or situation, the biggest risk is not taking steps down/ along the road in the first place.

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www.nvestwealth.com

10268 Sawmill Parkway

Powell, Ohio 43065

Ph: 614.389.4646

Fax: 614.389.4646

Email: info@nvestwealth.com