Monthly Commentary

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Power in Small Numbers

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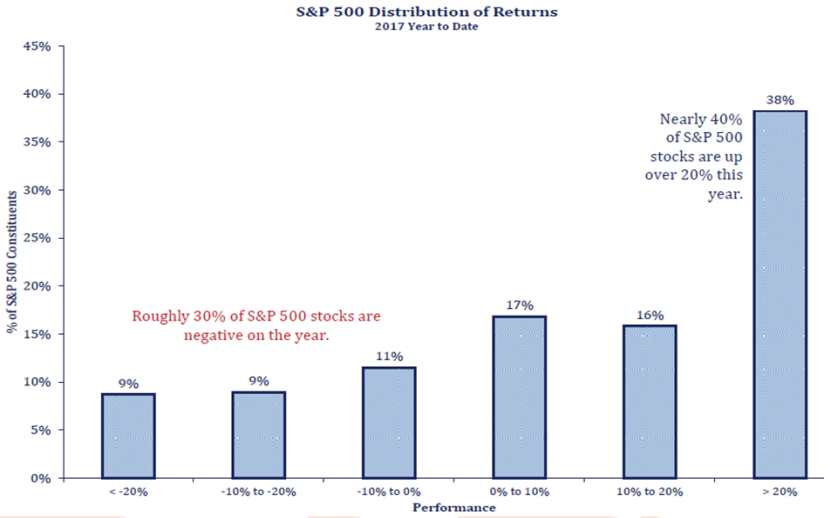
Today's world is run by numbers. Television shows are produced or canceled depending on ratings. Politicians rise or fall depending on polls. We are often evaluated based upon numbers – grade point average, or performance scores. Mutual funds are rated on past history using a numeric star rating system. An entire book of the Bible is named Numbers. "Does anyone know what time it is" (numbers)? Numbers help bring order to our lives. Even zero is an important number in all of math. Some math-oriented individuals might even espouse that "numbers are life."

There is power in small numbers. A political issue can be determined by just one vote. Sometimes, small numbers can create frustration, particularly for investors earning small-number returns, as during the last few years. Yet, long term investment success is often more the product of small monthly or quarterly returns that link together to create big numbers over time. The magic of *compounding* (chain-linking) small numbers grows into big, amazing numbers over years. Looking at 2017, it may be safe to say that there are investors frustrated by the high frequency of small daily returns. Some may feel comfortable by the low volatility in the stock market, while others (skeptics) feel frustrated that the rally of over 16% for the S&P 500 is big and was not anticipated. In fact, the current Bull market, now 103 months old (over 8.5 years since March 2009), is widely viewed as a rally that no-one loves. This year through October, the S&P established 52 new highs – that's a lot of new highs. Interestingly, 25% of the 209 trading days this year produced a new high. Further, 50% of the new daily highs were achieved with less than a quarter-of-1% increase for the day; and 73% of the daily new highs were achieved with a rise of a half-percent or less. But these frequent small daily price increases linked together are producing the first big year of performance for stock investors in 3 years.

A bull market should make investors happy; this one isn't. This bull market is testing the nerves of all investors. With the market "up again," the question gets louder – When will it end? Most feel valuations are high and that good alternatives do not exist. Investors understand how much work it takes the markets to accumulate attractive returns from small daily numbers; and how quickly it seems a drawdown can erode some or much of it. Yet, to earn attractive, albeit small daily price increases, an investor must be invested. Dissecting the market - returns are bifurcated under the surface. The S&P500 index is up over +16% through October - nearly 40% of the constituents are up +20% or more, but another third are actually negative YTD.



These themes are visible in client portfolios as well; they too are experiencing a seemingly daily dose of new highs coinciding with the market experience. Each portfolio owns a variety of different style funds, yet not all share the same YTD joy. International is providing the best total returns in 2017, with large company stocks not far behind. Growth style is besting Value style stock pickers. The slowest performer is small value. Bonds are doing okay, particularly corporate bonds that offer some interest rate advantage to US Treasuries.

Style	October	YTD
S&P 500	*+2.3%*	*+16.9%*
Large-Cap Stocks	+2.1%	+15.9%
Avg US Stock Fund	+1.7%	+14.4%
Foreign Stocks	+1.6%	+23.8%
Mid-Cap Stocks	+1.5%	+11.4%
Small-Cap Stocks	+1.2%	+9.8%
Barclays Bond Idx	+0.1%	+3.2%

Client Objectives (Stocks/Bonds)	October	YTD
20/80	+0.4%	+4.9%
35/65	+0.7%	+7.4%
50/50	+0.8%	+8.6%
65/35	+1.2%	+11.4%
80/20	+1.6%	+14.5%
95/5	+2.0%	+16.7%

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2017 may prove, in retrospect, to be a turning point year for the current bull market. While the average bull market runs 60 months (5 years) and this one is 103 (not the longest that ran 120 months), its advance is largely attributed to financial repression (zero and/or low interest rates), engineered by the world's central banks since the global financial crisis (2008). That defining theme for investors is ending as the Fed and other monetary authorities begin to unwind QE events and raise interest rates. The unwinding of QE policies is the first such experience for the world financial markets ever. The run-off will occur as maturities of the bonds purchased under 3 separate QE actions cause the $4.2 trillion portfolio held by the Fed to slowly shrink. This will be occurring at the same time the Fed continues to slowly raise the base interest rate (four 25 basis point increases in the past year). Financial repression stabilized the economy, but also created small-number investment returns for most all investors.

The challenge to reverting back to more normal monetary policy (from financial repression) relates to the speed of the change. Financial markets do not like abrupt; they like small number changes. Both the US and global economy are experiencing a synchronized economic boost not present since 2008. Global economic growth is picking up, without inflation. The Fed and other monetary authorities want to normalize interest rates and policy, but must be slow and careful. They want the QE runoff to be as boring as possible (like being on "auto pilot"). They know raising interest rates too fast will increase the cost of borrowing money; wherein high debt companies (most everyone dislikes higher interest rates) will struggle to pay higher interest expenses and could curb economic growth and prompt an economic slowdown. Keep in mind that this is not the current environment today – interest rates are slowly being adjusted higher, and the yield curve is not inverting (condition where short rates are higher than long rates). If bonds were to lose value quickly from a quick change in monetary policy, and/or if the bond market were deemed as less-liquid (due to Dodd-Frank that limits bankers from owning bonds), the "average person" could suffer an unusual loss from bonds. Some bond funds are extended "out on the limb" - they own longer and/or lower quality bonds in an attempt to produce higher current returns to attract investors. Investing in bonds remains challenging because of their small number returns (low yields); but they provide attractive diversification benefits to investment portfolios.

For investors, it is this same low interest rate environment supporting the current bull market, which also created a boost to passive index investing. Passive investing was boosted because low interest rates permitted even highly leveraged (indebted) companies to remain alive in a slow growth economy. Good performance accrued to "own it all", not being selective. Did you know, about one-third of the small companies in the Russell 2000 index failed to earn a profit in the past 12 months? In many ways, passive strategies feel like a developing "bubble". In recent years, the money flow (the herd) from active to passive is enormous. As money flows to passive, it pushes up the values of all stocks the index owns, without differentiation. You might be surprised to know that the number of ETFs and passive strategies now total more than the number of underlying stocks which comprise them.

So, as interest rates are now being increased, financial repression will disappear, and investment returns (from bonds and stocks) should normalize. Under such conditions, passive investment strategies may be challenged as investors again care which companies are highly leveraged and/or poorly run, as they would be most vulnerable to the rising cost of borrowing money. Be reminded, passive strategies will experience the full direction of a drawdown, as they are designed to replicate their index both up and down. Is there investor euphoria today? No; maybe because so many investors own passive strategies that are boring (not like owning individual stocks with a story).

So how will the current bull market end? Be aware of economic history as it provides some ideas. No recession started when corporate profits were buoyant; financial markets historically cared very much about earnings, like today. Similarly, no recession started without being preceded by an inverted yield curve and rapidly rising inflation. When bond yields and stock prices slowly rise at the same time, it's viewed as a sign of a strong economy - that best characterizes the environment today. Looking at interest rates in 1929, going into the Great Depression, the policy rate was 6% with bond yields at 3.4% (inversion of -260bp). At the Dow Jones market peak in 1973, the policy rate was 11.25% with bond yields of 7.25% (inversion of -400bp). Or in 1990, going into Japan's Lost Decades, their policy rate was 8.3% with bond yields at 6.4% (inversion of -190bp). Similar inversions existed in 2000 and 2007; the inversion was -125bp and -70bp, respectively. Today, the policy rate is 1.25% and the 10 year T-bond yield is 2.32% (positive yield spread of +107bp). The "end" will likely be associated with inflation accelerating and aggressive Fed or global central bank tightening. Bottom line: pursuing a slow normalization of policy and rates provides time before we see global financial conditions become truly tight. A slow advance of inflation and a synchronized global reflation of the economy are good ingredients for this business cycle, allowing it to continue and support further stock market advances. It doesn't look like the end at this point.

So, can investors develop any direction or takeaway from a year of many small-daily highs that create a big YTD number return? The last time the NASDAQ produced so many new daily highs in a year, was 1999 (61 then following 4 other years of 30 to 50 new daily highs; compared to 63 in YTD-2017 - the first year in this century with numerous new daily highs). Most likely, the changing market backdrop – from financial repression to normalization while adding fiscal stimulus is creating synchronized global growth with a low-inflationary tailwind – will continue this bull market run for a while. Expect too, the bull will run with different, more selective leadership – passive may see less benefit versus active strategies. We are always evaluating tactical adjustments to client portfolios because of changing market and economic dynamics. In the meantime, enjoy the merits of small numbers. They compound into big returns over time.

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