COMMENTARY

PRIVATE CAPITAL MANAGEMENT

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Second Quarter 2017

"The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults." –Alexis de Tocqueville

The first half of 2017 has been a good year for the stock market. Through June 30th, the S&P 500 is up +9.3%, the MSCI EAFE international stock index is up +13.8%, the MSCI Emerging Markets stock index is up +18.4%, and even the Barclays Aggregate Bond Index is up +2.3%. Remarkably, the Russell 1000 Growth Index is outperforming the Russell 1000 Value index by 9.3% year-to-date. A recent analysis from Research Affiliates, LLC notes that the trailing five-month performance of U.S. value stocks versus their growth counterparts is within the worst historical fifth percentile across all rolling five-month periods since 1968.[1] This is a complete reversal from last year when the Russell 1000 Value index outperformed the Russell 1000 Growth index by 10.3%.

This year, a very small number of stocks in the S&P 500 have accounted for a disproportionate amount of its gain. This small grouping of stocks is now regularly being referred to as "FANMAG" (**F**acebook, **A**mazon, **N**etflix, **M**icrosoft, **A**pple, and **Google**). James Bianco, of Bianco Research, recently emphasized that the current rally is the most concentrated since the 1995-2000 tech bubble and that these six stocks alone account for nearly half of the market's year-to-date gains.[1] Research Affiliates warns that, on a weighted-average basis, these FANMAG stocks trade at a P/E ratio of 56x earnings, which is more than twice that of the S&P 500. In aggregate, these six stocks are trading at a price-to-sales multiple that is a 67% premium to the market despite having a 56% lower weighted dividend yield.[1] We believe that these swings in relative performance between growth and value stocks, and the narrow leadership in the stock market, warrant maintaining a well-diversified portfolio.

International Stock Market Update

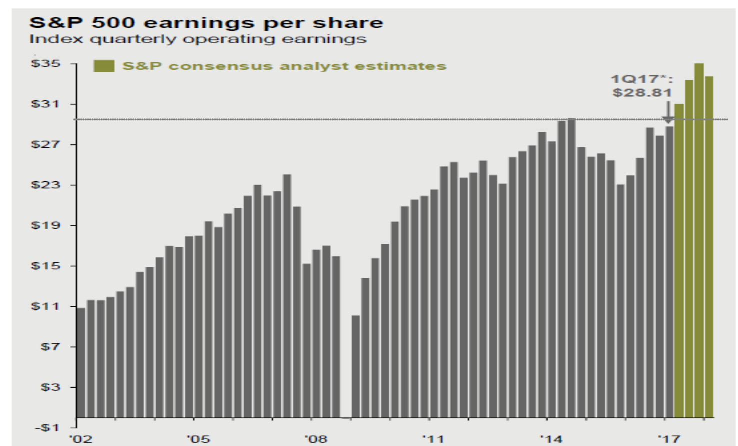
In our Fourth Quarter 2016 commentary, we noted that the MSCI-EAFE international developed market stock index had been lagging behind the S&P 500 in recent years. At that time, the rolling 10-year compound rate of return was rivaling the second worst on record. But, we felt investors should maintain exposure to international investments for diversification purposes. This year the MSCI-EAFE index is outperforming the S&P 500 by 4.5%. Relative sentiment on international stock markets has been improving as valuations on the U.S. stock market have risen to somewhat elevated levels.

Mixed Signals

The first half of 2017 has been a good one for most diversified investors because stock and bond prices have both been rising. Stocks have been going up based on continued optimism about potential fiscal policy reform, which we discussed at length in last quarter's commentary, and because corporate earnings growth has been resilient. On the other hand, bond prices have been rising on increasing skepticism due to lackluster economic data. For example, first quarter real GDP growth was only 1.4%. It is worth noting that the bond market is significantly larger than the stock market. In the U.S., the bond market is estimated to be about $40 trillion, while the stock market is only about $20 trillion.

Jeffrey Gundlach, CEO of DoubleLine and Portfolio Manager of the Doubleline Total Return Bond Fund, recently noted on a conference call that Real GDP growth over the last 10 years ending 2016 was only 1.33%, which was the same level during the depth of the Depression in the 1930s.[2] For the last 8 years, Real GDP growth held fairly steady at around 2%, but approximately $10 trillion of debt has been added to the deficit over the last decade.[2] Accordingly, Gundlach believes that, without the debt fueling growth, GDP growth would have been only 0.7%.[2]

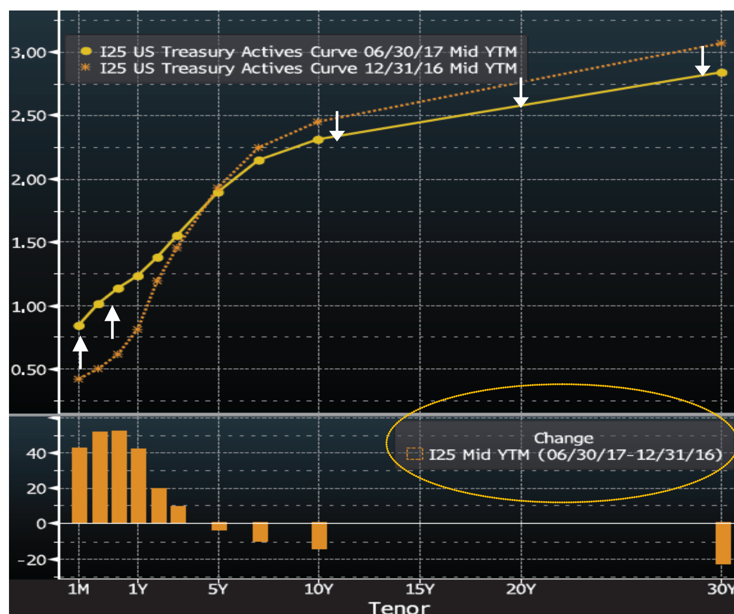
In the long run, the stock market is driven by corporate earnings which are indirectly tied to economic growth. As the next chart from J.P. Morgan Asset Management shows, 1Q17 S&P 500 earnings are near record levels, and future earnings are projected to set new records in the quarters ahead in spite of weak U.S. economic growth.



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. EPS levels are based on operating earnings per share. Earnings estimates are S&P's consensus analyst expectations. *1Q17 earnings are calculated using actual earnings for 98.6% of S&P 500 market cap and earnings estimates for the remaining companies. Data are as of 6/30/17.

As expected, the Federal Reserve raised short-term interest rates 0.25% at its June meeting. This marks the fourth rate increase since 2016 and brings the federal funds target rate range to 1.00%-1.25%. But, as we mentioned earlier, bond prices have been rising this year causing longer-term interest rates to decline. When short-term rates rise and long-term rates fall, the slope of the yield curve flattens. The chart below from Bloomberg shows the yield curve

has flattened some since the beginning of the year, but it has not inverted (when short-term rates go higher than long-term rates).



Source: Bloomberg as of 7/10/2017

We keep an eye on the yield curve because it has historically been a reasonable leading recessionary indicator when the yield on the 10-year U.S. treasury minus the yield on the 1-year treasury has dipped below +0.38%.[3] As of June 30th that yield spread was still +1.07%.

No Signs of a Recession, Yet

The economic expansion reached its eighth year in June, making it the longest expansion since WWII at 96 months, versus an average of 58 months for the previous 11 expansions.[3] But, this expansion's 17.5% cumulative growth in real GDP ranks it only 7th and below the average increase of 25%.[3] The current 4.4% unemployment rate is the fifth lowest of these prior expansionary periods.[3] CFRA Chief Investment Strategist, Sam Stovall, notes that the absence of an initial jack-rabbit start to this expansion, combined with non-exhaustion-level readings, makes him think that the gradual growth will allow for a prolonged overall expansion. Additionally, a recent Bloomberg survey of economists put a 60% probability, based on the median estimate of the 42 respondents, on the growth streak running through at least July 2019, and a 30% probability it will run through January of 2021.[4]

CFRA tracks four economic measures to monitor recessionary risks: 1) housing starts, 2) consumer sentiment, 3) leading indicators and 4) the yield curve. They believe three out of four need to fall into negative territory before the risk of a recession becomes elevated. Currently, the only point of concern is housing, which was down -2.4% year-over-year. But, CFRA notes that, since 1960, housing starts fell an average of 25%, and a minimum of 10%, before a recession started. Current readings are a far cry from those levels.

According to Goldman Sachs Asset Management, the economic expansion has deepened and synchronized around the globe, with 98% of world economies participating, and they highlight broad inputs such as improving labor markets, accommodative monetary policy, supportive financial conditions, favorable sentiment, and the potential for fiscal impulses. In the next chart, GSAM estimates the probability of a U.S. recession within the next nine quarters is at 31%, a level which presaged 3+ years of economic growth before the most recent three recessions even started.

Recession Risk: Down, But Not Out

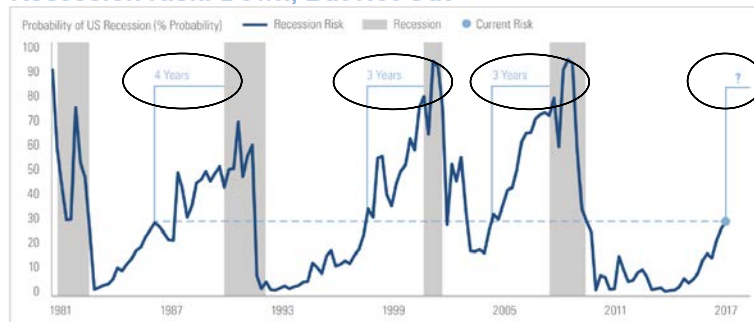


Chart Source: Goldman Sachs Global Investment Research, National Bureau of Economic Research, and GSAM. As of May 31, 2017. The chart shows quarterly data of the unconditional probability of a US recession in the next 9 quarters from January 1981 to March 2017, the latest available data. The lines show the amount of time from current levels (31%) it has historically taken to enter a recession, as defined by the National Bureau of Economic Research. The economic and market forecasts presented herein are for informational purposes as of the date of this document. There can be no assurance that the forecasts will be achieved. **Past performance does not guarantee future results, which may vary.**

"Land of the Free Because of the Brave"

On the 4th of July, we came across this statement that we believe exemplifies the courage and sacrifice of all the men and women who have fought for our freedom. We would like to take this opportunity to thank all of our service men and women, past and present, for all that they have done for this wonderful country.

By the numbers…

Index	Close	2nd Quarter	Year-to-Date
S&P 500	2423	+3.1%	+9.3%
Dow Jones Industrial Average	21,349	+4.0%	+9.4%
Russell 2000	3517	+2.5%	+5.0%
MSCI EAFE	1883	+6.1%	+13.8%
MSCI Emerging Markets	1010	+6.3%	+18.4%
Barclay's US Aggregate Bond	-	+1.5%	+2.3%
Bloomberg Commodity	82	-3.0%	-5.3%

Domestic total return and international net return data provided by Morningstar as of 6/30/2017

1 West, John, CFA, and Amie Lo, CFA. *Are You Underweight FANMAG? Chillax!* Rep. no. June 2017. Newport Beach: Research Affiliates, LLC, 2017.
2 Huebscher, Robert. *Gundlach: Rates are Going Up*. Rep. no. June 14, 2017. Lexington, MA: Advisor Perspectives, 2017.
3 Stovall, Sam. *U.S. Equity Research Sector Watch H20: Second-Half Outlook*. Publication no. June 16, 2017. New York, NY: CFRA, 2017
4 Chandra, Sho, and Steve Matthews. "Don't Underestimate This U.S. Expansion: It's Headed to a Record." *Bloomberg Politics*. Bloomberg, 15 June 2017. Web. 7 July 2017.

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