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2017 Second Quarter Review
"The Great Unwind"

By the end of the second quarter, the stock market continued to slowly grind higher even as enough political controversy was thrown its way as to cause previous markets to swoon, at least temporarily. Large technology companies led the advance while energy and real estate were the only sectors that actually declined. The S&P 500 and the Dow Jones Industrial indexes gained 8% while the smaller companies represented by the Russell 2000 index were up less at 4.8%. Precious metals prices improved with gold gaining about 8% for the first half of the year as well. The Federal Reserve Board has continued to raise short term interest rates for the third time in the past year. Oddly enough, the yield on the US 10 year Bond has fallen from 2.44% to 2.26% during the first six months of the year. However, it still appears that the historic low rate of 1.39% on the "10 Year" that was reached almost exactly a year ago may prove to be the peak of the long term bull market for bonds that started in the 1980s.

Sometimes experience and a working knowledge of history can be a hindrance. The average investor may not know that the historical p/e ratio for the S&P index was over 21 recently, a level that the market has only exceeded a few times since the 1950's, and several of those times was right before major declines. Stock market valuations are now 1.3 times US GDP, and that has only happened twice before; in late 1999 and early 2007. What is often forgotten as bull markets progress is the fact that risk is the first thing that should be looked at in any investment. The first consideration should be return *of* capital. Only then should possible returns *on* capital be assessed. The risks in the current market are so numerous and unusual that I have attached a separate list (including comments from Doug Kass of Seabreeze Partners). That seemed to be the most efficient way to frame the context within which we are investing.

To summarize, stocks are statistically expensive in general but the market has continued to rise. This often happens late in bull cycles as the pendulum swings from cheap to expensive and momentum carries prices past more reasonable valuations. We certainly saw that phenomenon in early 2000 and again in 2007. However, the world central banks have created so much money in the last several years that the "sloshing effect" of all that liquidity may carry markets to still-higher levels with even more over-valuation. Add to that the increased influence of "algorithmic trading" and passive ETF investing and you have enough fuel to inflate another expansion of a bubble in asset prices. The good news is that we don't see some of the excesses that often mark late-stage bubble buying. However, some people do and that is one reason that I attached the enclosed list of risks.

One of the more unusual aspects of this recent advance has been its lack of setbacks. There has been a rare, smooth buying pattern that has not given those of us who try to buy at better values the opportunity to take advantage of sell-offs. When you hear mention of the historically low "VIX" index in financial news reports, *that* is what they are talking about. The VIX is a volatility index, and volatility has remained unusually low in this more recent advance. Some interpret this as "investor complacency" that is common near market tops as little fear is shown until prices start to fall and losses mount. Others call it the calm before the storm.

Our first priority is to preserve your assets and we have to take several levels of risks into account in order to do that. We also have no idea if the inflation in financial assets (that has been sparked and fed by the world's central banks creation of unprecedented amounts of credit after the financial crisis) is nearing the end of its course or not. We DO know that the Fed is raising interest rates AND planning to shrink their balance sheet (sell the bonds they have bought). This is what they used to call "taking away the punch bowl" before the party got out of hand. In previous cycles, the party wasn't as large and the punch bowl was nowhere near its current swimming-pool size.

Jamie Dimon is the CEO of JP Morgan Chase. He heads one of the largest financial institutions in the world and is one of the world's most respected bankers. Here is a quote from his recent remarks at a meeting in Paris:

'We've never had QE (quantitative easing) like this before, we've never had unwinding like this before. Obviously that should say something to you about the risk that might mean, because we've never lived with it before... When that happens of size or substance, it could be a little more disruptive than people think. We act like we know exactly how it's going to happen and we don't.'"

We are in the same boat as Jamie Dimon. We don't know if the change in policy will cause disruptions or not. We don't know how this great experiment in central bank intervention will unwind. We do know that the policy has changed, interest rates are rising, and the quantitative easing has stopped in the US, and may do so soon in Europe as well. The market seems to be saying that corporate earnings will soon jump in order to justify current valuations. If earnings don't jump high enough, there could be some of Mr. Dimon's disruptions ahead of us. Consequently, we will pick our positions carefully and be prepared for that risk.

You will find your portfolio reports and statements enclosed. Please review them at your leisure and call us with any questions or suggestions. By all means, if you want your investments to be more or less aggressive than those currently, please give me a call and we will discuss changes to reflect your personal risk tolerance.

Sincerely,

Claude Carmichael CFA