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Subject: 1st Quarter 2017 Review

This letter is intended to review your portfolio results relative to the market as of the end of the first quarter 2017. Also, the intent is to keep you up to date with some of the key macroeconomic happenings. Note: if the commentary section is too long for you, just read the bold print and the conclusion section.

Attached you will find a summary perspective on the market and the economy, performance comparison of growth and value stocks by asset class, and your personal portfolio reports including Performance Analysis from inception through March 31, 2017, Index results from 12/31/16 to 3/31/17, Position Performance Summary from 12/31/16 to 3/31/17, Portfolio Statement, and Yield Analysis.

Stock Perspectives / Growth vs. Value

- **A 100% stock portfolio with dividends reinvested was up 5.81% through the end of the first quarter**.
- Value stocks turn in the limelight in 2016 has receded in 2017. The stock markets have been under the influence of animal spirits released by the election of Donald Trump in November. This now referred to as Trump trade. 2017 is beginning to look like 2015 with companies bereft of earnings becoming all the rage. The cash burning company Tesla, now has a market cap greater than Ford Motor Company. **The Total Return Results page shows Growth leading Value by 5.77% through March 31st this year.**
- The trailing twelve month P/E ratio of all small cap stocks is now 127. But, if one looks only at small cap stocks that earned a profit, the P/E ratio is a somewhat reasonable 28.7.
- **Valuations are on the high side**, **but growth stocks are skewing the overall valuations above the fair value range. Based upon P/E ratios, it would be safe to say that value stocks as a whole are valued above the mid-point of the fair value range and rising towards the high end.**
- **More on valuations: Price to book value ratio for Growth stocks is 10% above their long term average. Price to book value ratio for Value stocks is 10% below their long term average.**

Bond Market

- **The Federal Reserve wants to steer interest rates very gradually upward. The good news is that the Fed is confident that the US economy is on solid footing.** The Fed raised the Federal Funds rate (rate at which banks lend each other money over-night) by 0.25% in December and again in March. Since, the March increase**, the 10 year Treasury rate has declined from 2.60% to 2.30%. As a result, short term bonds were up 0.67% in the first quarter and intermediate bonds (Barclays Aggregate) were up 0.86%. This contrary reaction to raising the Fed Funds rate points to a dilemma for the Fed. They feel the need to raise interest**

rates, yet the act of doing so attracts foreign demand for intermediate and long term U.S. bonds, which drives interest rates down. This results in a flatter yield curve. This is not an outcome the Federal Reserve wants to achieve, as a flatter yield curve would cause earnings problems for banks and therefore a reduction in lending from banks.

- **The Federal Reserve may have to reduce their plans for three or four rate increases in 2017.**
- The difficulty in raising interest rates may extend the time-frame needed to increase interest rates to a level that will likely be 1.5% below historical norms. **This makes for a difficult environment for bond/income investors - but, good news for borrowers.**
- **We continue to focus on and seek bond funds with interest rates higher than duration.**

<u>Commentary</u>

- 3rd Quarter 2016 Real GDP: final reading was 3.5%.
- 4th Quarter 2016 Real GDP: third revision 2.1%.
- Estimates for 1st Quarter 2017 Real GDP are for 1% or less. The first quarter has been a slow quarter in recent years. The explanation this year seems odd; warm weather hurt utility output. In previous years, bad weather hurt economic activity in the first quarter.
- **Projections for the 2nd Quarter and the year center on 3.3% and 2.5%, respectively.**
- It seems that **politics are taking an inordinate amount of attention in setting expectations for the economy in the near term.**
    - **Mr. Trump's election initially brought hope of reduced regulations and tax rates.** But, the failure of his administration to replace the Affordable Care Act has drawn into question the ability of his administration to pass legislation focused on his agenda. In fact, his agenda is becoming difficult to pinpoint as specifics have been vague as well as a moving target. Fractions within the Republican Party stand in the path of Mr. Trump's identified goals of ACA replacement (over Medicaid limits) and tax rate reductions (over budget deficits). **Gridlock may be the order of the day.**
    - **Europe's nationalistic voices are being heard. Brexit is in process.** Denmark voted against Euro-skepticism. Chances of a Frexit appear lower after their vote on Sunday. Although Frexit fan, Ms. Le Pen is in the election run-off. She trails in polls by a wide margin. **The lessened threat of Frexit has led to France's stock market reaching a two-year high on 4/25/17.**
    - **An additional national exit from the Euro-zone would likely lead to a break-up of the Euro. This would cause significant economic disruption in the short term.**
    - **Equities markets typically don't like uncertainty. There seems to be plenty of national policy and geopolitical uncertainty to go around**, not mentioning Syria, Iran, and North Korea. Yet, the equities market reaction has been muted. **It would appear that market emotions are in check at the present time.**
- **The economy must grow if corporate sales and earnings are to grow. This certainly would be a prerequisite for further gains in the stock market.** So, let's take a look at some leading and concurrent economic indicators for some indications. **You will find a case for continued economic growth.**

- **Housing is strong**: Building permits (up 10.4% from 2016), new home construction (up 8.1% from 2016), and existing home sales continue to trend upwards. Although, new construction still trails new family creation by 200,000 per year. Mortgage rates remain low. So, the potential for growth remains strong.
- **Institute of Supply Management: Readings above 50 means growth.** Readings above 60 are rare.
- Institute of Supply Management - **Manufacturing: 57.2.** Manufacturing has been on a strong up-trend since August 2016. It has been hovering above 57 for three months. **Historically, this level correlates to 4.5% GDP growth. We are not suggesting that this kind of growth is in the cards. But, it gives you an idea of how elevated this reading is.**
- Institute of Supply Management – **Service: 55.2.** Readings have been above 50 since early 2010.
- **Consumer confidence (actually a trailing indicator): End of March reading was 124.9. This was the highest reading since the year 2000.**
- Employment
  - **Monthly hiring is strong:** 2015 average was 220,400. 2016/17 average is: 192,600. By my math, in accounting for improvement in under/unemployment and employment participation rate, the U.S. is 26 to 35 months away from full employment. If the pace of hiring slows, the timeframe to full employment is even longer.
  - **Four week moving average for unemployment claims – lowest since 1970's. This reading has been below 300,000 for 109 weeks in a row. Below 300,000 points to substantial monthly hiring.**
- **Orders for durable goods are picking up in 2017.** Historically, this is a volatile reading. It has averaged 0.33% gains since 1992. So far this year we are averaging 2% per month.
- **Corporate earnings trending back up:** The stabilization of the price of oil has helped corporate earnings to trend up. Earnings are no longer being pulled down by the energy industry. Saudi Arabia is pushing OPEC to continue the reduction in production in spite of the reopening of wells in the U.S. **U.S. oil/natural gas production efficiency gains are running at 20% per year.**
- **Financial Stress Index is very low (lack of stress).** The average reading in 2017 is negative 1.276. Negative 1.0 is a very low reading, meaning **positive for the economy**.

- **Risks: Stock Valuations, Political Uncertainty, Strength of Dollar, Public Debt**
  - Stock Valuations: discussed in Stock Perspectives section. **Growth stocks are at greatest risk of being miss-priced. This is an understatement.**
  - Political Uncertainty: Discussed in the commentary section, fifth bullet.
  - **Strength of the Dollar:** This has been an on and off issue for two years now. Projections for continued gains for the U.S. dollar in 2017 have been wrong. Europe is gaining strength and this should continue provided there aren't any more nations exiting the Eurozone. China's demand economy seems to be just o.k., but debt issues lurk. Japan is

making slow progress. Other emerging markets are doing well. **All in all, this is likely a lesser threat than anticipated given the economic improvement outside the U.S.**

- **Public Debt:** It is important that the world economies stay on a track of improvement. Most governments and central banks have used up resources to recover from the Financial Crisis. **Government budgets are strained and Central Bank balance sheets are bloated.**

<u>Conclusion</u>

- Economically, the positives significantly outweigh the negatives.
- Absent geopolitical risks, one can envision an even longer extended slow economic growth period.
- Portfolio performance results: Bonds beat the short and intermediate term indexes. Stocks trailed their respective index, but significantly beat the growth vs. value spread.
- We remain focused on value investing and seeking income as well as long term appreciation of investments.

Please feel free to contact us with any questions, or if you would like to schedule a meeting.

Thank you,

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