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FINANCIAL MANAGEMENT, INC.

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Subject: 2017 - 2nd Quarter Review

The intent of this review is to keep you up to date with some key securities market and macroeconomic happenings. Note: if the commentary section is too long for you, just read the bold print and the summary / conclusion section.

Stock Perspectives / Growth vs. Value

- **A 100% stock portfolio with dividends reinvested was up 9.56% through the end of the second quarter**.
- Value stocks turn in the limelight in 2016 has capitulated to growth in 2017. The stock markets had been under the influence of animal spirits released by the election of Donald Trump in November. This was 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 General Motors and Ford Motor Company. **Growth leading Value by 9.56% through June 30th this year!**
- **The Trump trade appears to be fading and is being replaced by a focus on actual and significant gains in earnings.**
- The trailing twelve month P/E ratio of all small cap stocks is now 87.6. But, if one looks only at small cap stocks that earned a profit, the P/E ratio is a somewhat reasonable 26.8.
- **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 U.S. 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, in March, and again in June. Since the March increase**, the 10 year Treasury rate has declined from 2.60% to 2.31%. As a result, short term bonds were up 1.24% in the first half and intermediate bonds (Barclays Aggregate) were up 2.39%. This contrary reaction to raising the Fed Funds rate points to a dilemma for the Fed. They feel the need to raise interest rates to fend off higher inflation, 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 (smaller spread between short and long term interest rates). 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 has noted a near term pull back in inflation from their target of 2.0% to 1.7%. They appear to be reducing their plans for three or four rate increases in 2017. Although, they are indicating that they will begin reducing their balance sheet of U.S. Treasury bonds and mortgage backed bonds by the end of September. These plans to tighten money supply from an extremely loose level, is very gradual.**
- 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.**

Commentary

- 3rd Quarter 2016 Real GDP: final reading was 3.5%.
- 4th Quarter 2016 Real GDP: final reading was 2.1%.
- 1st Quarter 2017 Real GDP: final reading was 1.2%. This is an increase from an original estimate of 0.9%.
- 2nd Quarter 2017 Real GDP: first estimate was 2.6%. This is lower than most projections of 2.8% to 3.3%.
- **Projections for the year have been reduced from 2.5% to 2.2%.**
- 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.**
    - **Beyond Brexit, Europe's nationalistic voices have been significantly quieted.** Economic growth rate in Europe is projected to be 1.9% for 2017. France's government unveiled its reform agenda, which focuses on rekindling finances and boosting growth, as politics are finally in the rearview mirror following a long election cycle. Greece managed to return to the financial markets last week with the sale of government bonds.
    - **We do not have great confidence in a common currency for Europe given the disparity of economic success by country. The common currency eliminates the ability of a country to be able to deflate their currency as a tool to recover. For now, there is relative calm and economic progress being made.**
    - **Equities markets typically don't like uncertainty. There seems to be plenty of national policy and geopolitical uncertainty to go around**, including Russia, 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 5.1% from 2016), new home construction (up 2.1% from 2016), and existing home sales continue to trend upwards, but the trend is weakening due to a shortage of supply. Inventory of existing homes available for sale has shrunk to 4.3 months. This is critically low, 6 months is considered a good balance. New construction still trails new family creation by 200,000 per year. Mortgage rates remain low, but with the supply of existing homes low, prices are rising fast, 5.6% this year so far. The potential for growth remains strong, but construction must pick up.
    - Spending on home upgrades and remodeling is hitting record levels due to the shortage of existing homes for sale.
  - **Institute of Supply Management: Readings above 50 means growth.** Readings above 60 are rare.
  - Institute of Supply Management **- Manufacturing: 57.8 – June reading.** Manufacturing has been on a strong up-trend for the last 10 months. It has been hovering between 54.8 and 57.8 for six 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: 57.4.** Readings have been above 50 since early 2010. The readings this year range from 55.2 to 57.6.
  - **Consumer confidence (actually a trailing indicator): End of June reading is still high at 121.1.** This puts present conditions confidence at a 16 year high. Overall, consumers foresee the current economic expansion continuing well into the 2nd half of this year.
  - Employment
    - **Monthly hiring is strong:** 2015 average was 220,400. 2016/17 average is: 178,333. 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. **Four week moving average for unemployment claims – lowest since 1970's. This reading has been below 300,000 for 123 weeks in a row. Readings below 300,000 point to continued 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 1.57% 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 1.375. 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, sixth 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. The dollar is down 6.5% vs a broad basket of world currencies. 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. Presently, the relative decline in the value of the dollar has been a net positive for manufacturing and exports.**
    - **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>Summary / Conclusion</u>

- Economically, the positives significantly outweigh the negatives.
- Absent geopolitical risks, one can envision an even longer extended period of slow economic growth.
- Portfolio performance results: Bonds have bested the short and intermediate term indexes. Stocks have trailed their respective index, but have beaten the growth vs. value spread.
- Much has been written about the length of this bull market, low stock price volatility, and concerns that the market is priced to perfection. One cannot predict the future, but the case for high valuations and excellent corporate earnings leaves one wondering how much longer or higher can the stock market trend. We don't have the answer, but we do believe there is strong potential for continuing economic gains. The market is bifurcated from a valuation standpoint. In general, there is no question that growth stocks are over-valued. In general, value stocks are not. But, when the market confidence switches to negative, all stocks will be affected. If a change in market confidence to negative were to extend beyond near term, growth stocks will receive much harsher treatment than value stocks.
- 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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