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FINANCIAL MANAGEMENT, INC.

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Subject: 2017 – 3rd 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 14.66% through the end of the third quarter**.
- Value stocks turn in the limelight in 2016 has capitulated to growth in 2017. **Growth is leading Value by 12.71% through September 29th 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 98. But, if one looks only at small cap stocks that earned a profit, the P/E ratio is a somewhat reasonable 26.2.
- **Valuations are on the high side**, **but growth stocks are skewing 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, where Growth stocks are valued above the fair value range.**
- **Price to book value ratio for Growth stocks is about 10% above their long term average. Price to book value ratio for Value stocks is about 10% below the 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 2016, in March, and again in June this year. Since the March increase, the 10 year Treasury rate has declined from 2.60% to 2.35%. Despite the Fed's action, short term bonds were up 1.76% through the first three quarters and intermediate bonds (Barclays Aggregate) were up 3.31%. 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 bond yields 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.
- **Because of this challenge, it may take the Fed longer to arrive at a point of interest rate normalization, which may be 1.5% below historical norms. This is consistent with our**

lower for longer view of interest rates. This makes for a difficult environment for bond/income investors - but, good news for borrowers.

- The Federal Reserve has noted a near term pull back in inflation from their target of 2.0% to 1.7%. They did not raise interest rates at their meeting this week. They did indicate that they are targeting one more increase in December this year and three increases in 2018 as they do anticipate that inflation will rise towards their 2% target. They began reducing their balance sheet of U.S. Treasury bonds and mortgage backed bonds in October. These plans to tighten money supply from an extremely loose level, is very gradual.
- **We continue to focus on and seek bond funds with interest rates higher than duration.**

Data and Commentary

- 2016 Real GDP growth: 1.6%
- 1st Quarter 2017 Real GDP growth: final reading was 1.2%. This is an increase from an original estimate of 0.9%.
- 2nd Quarter 2017 Real GDP growth: final reading was raised to 3.1%.
- 3rd Quarter 2017 Real GDP growth: first estimate was 3.0%, in spite of the two hurricane punch.
- **Post hurricane rebuilding activity and car purchases will likely push estimates for 2017 GDP growth back towards 2.5% from 2.2%.**
- **Estimates for 2018 GDP growth are running at 2.7%.**
- **Last quarter we discussed the large impact of political news on setting expectations on the economy and the stock market. This inclination seems to have faded.**
  - In the USA, deregulation has been significant, yet stealthy. This doesn't jump to the headlines like Affordable Care Act debates and the failure to repeal and replace. NAFTA negotiations – not many headlines here as the negotiators agree to disagree.
  - In Europe, Brexit negotiations quietly continue on in the background. France avoided Frexit. It is all quiet on the Greece front. **Economic expansion began in the Eurozone in the 2nd quarter of 2013 and has remained positive for 18 quarters in a row. The growth rate is quickening in 2017 from 2.1% in Q1, 2.4% in Q2, to 2.5% in Q3.**
  - In China, Mr. Xi has consolidated more power while he exclaims that the communist party will lead the country to riches and superpower status. Watch for the party to seek greater control over corporations in China. **The biggest near term issue for China is high corporate debt. It is 160% of GDP. For comparison purposes, U.S. corporate debt to GDP is 30.7%.**
- Quarterly corporate results are grabbing more headlines. **Rewards (or penalties) of sales and earnings growth success (or lack thereof) are having greater sway over individual stock results, as opposed to an environment of a tide raising all boats.**
- We hear and read about concerns that stocks are over-valued and the bull market cannot continue on its path of continuous record setting. Is this the longest bull market ever in the USA? No. Where does this bull market rank? One would think that is an easy answer. But it depends upon which index you use to compare or if you use a logarithmic scale or not. The answer is that this is either the fifth or second longest. Throwing out the logarithmic scale, **this is the second longest bull market. 31 more weeks to tie the record. For long term investors, does it really**

matter if it is the longest and when will it end? No. But, inquisitive or worrisome minds want to have a general idea. Bull markets do not die of old age. The conditions that normally lead to significant market decline are either not present or not forecastable, including an oncoming recession, a hostile Federal Reserve, dangerous inflation, investor exuberance, speculative valuations or a geopolitical shock.

- **The Federal Reserve is the opposite of hostile. The Fed is actually very accommodative. Newly appointed Fed Chair, Jerome Powell is telegraphing little change in policy with the exception of a lighter hand on regulation.**
- **Dangerous inflation is not on any radar.**
- **Investor exuberance: Famous investor John Templeton argued that "bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria". This market does not resemble the euphoria the dangerous years of 1929 or 2000. Since this bull market began individual investors pulled money from stock mutual funds every year until last year. The inflow in 2016 and 2017 has not been exceptional by any means. We would estimate we are entering the optimism phase.**
- **Speculative valuations are present in some well-known growth stocks as well as some young biomedical companies. Speculative valuations certainly are not as pervasive as they were in the late 1990's.**
- **Geopolitical shock: North Korea.**
- **Oncoming recession: Not in view at this point. We are in a rare period of simultaneous worldwide economic growth. This economy is being referred to as the goldilocks economy, not to hot and not to cold. Normally we go in depth into statistics dealing with leading and coincident indicators – we will try to limit the commentary. You will find a case for continued economic growth.**

- **Economic Indicators:**
    - **Housing is strong, but growth may be leveling off**: Building permits and housing starts are up this year but appear to be leveling off. A lack of supply has driven home prices above 2006 levels. Building should be increasing at a greater rate, but a shortage of skilled labor and high development costs stand in the way. Mortgage rates remain low, but affordability has become an issue. 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: 60.8, 58.7 – September (a 13 year high) and October readings, respectively.** Manufacturing has been on a strong up-trend for the last 14 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: 59.8, 58.7. September (highest reading since August 2005) and October readings, respectively.** Readings have been above 50 since early 2010. The readings this year range from 55.2 to 59.8.

- **Consumer confidence (actually a trailing indicator): The October reading hit a 17 year high of 125.9.**
- Employment
    - **Monthly hiring is strong:** 2015 average was 220,400. 2016/17 average is: 177,750.
    - **The four week moving average for unemployment claims in down to 232,500 – this is the lowest reading since April 7, 1973. This reading has been below 300,000 for 140 weeks in a row. Readings below 300,000 point to continued substantial monthly hiring.**
    - **Since the 2nd quarter review, unemployment, underemployment, and the labor force participation rate has improved by 0.6%. By our analysis, we are still 3.4% away from full employment.**
- **Orders for durable goods are picking up in 2017.** Historically, this is a volatile reading. It has averaged 0.33% monthly gains since 1992. So far this year we are averaging 0.82% per month.
- **Corporate earnings growth is strong. Corporate tax rate reduction would add fuel to the fire.**
- **Financial Stress Index is very low (lack of stress).** The average reading in 2017 is negative 1.41. Negative 1.0 is a very low reading, meaning **positive for the economy**.
- **Strength of the Dollar: Presently, the relative decline in the value of the dollar has been a net positive for manufacturing and exports.**

Summary / Conclusion

- Economically, the positives significantly outweigh the negatives.
- Absent geopolitical risks, one can envision an even longer extended period of goldilocks economic growth.
- Portfolio performance results: Bonds have bested the short and intermediate term indexes. In light of the outperformance of growth, Equities have trailed their respective index, but have beaten the growth vs. value spread.
- We remain focused on the long view of 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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