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FINANCIAL MANAGEMENT, INC.

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Subject: 2018 2nd Quarter Review

The intent of this review is to keep you up to date with some key securities market and macroeconomic happenings. To shorten your reading time, read the bold print and the summary.

Stock Perspectives / Growth vs. Value

- **Growth stocks continue to outperform value stocks in 2018.**
- **Through the second quarter, a 100% stock portfolio with dividends reinvested was up 1.99%**.
- **Growth stocks lead Value stocks by 8.71% through the second quarter this year. Therefore, value stocks trail all stocks by 4.36%.**
- **The stock market had a very strong January. This was followed by an equally weak February and a more volatile and slightly upsloping pattern since then.**
- **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 between the mid-point and the high end of the fair value range, where Growth stocks are still valued above the fair value range.** An example of growth causing distorted valuations can be seen in the small cap index. The trailing twelve month P/E ratio is 88.4, yet if you exclude companies that did not make a profit, the P/E ratio is 21.3.
- **Price to book value ratio (P/B) for Growth stocks significantly increased to 7.32 since the Q1 ending P/B of 6.41, and is now 52% above the long term average (7.32 vs. 4.83). Price to book value ratio for Value stocks is 2.14 as compared to the Q1 ending value 2.01. This is now 5% above the long term average (2.14 vs. 2.03).**
- **With the help of the tax code change for 2018, corporations in the S&P 500 index saw their earnings rise about 25% in the 2nd quarter. This sort of growth in earnings is unheard of this late in the business cycle and comes on top of 23% growth in Q1.**

Bond Market

- **In the Q1 review letter, we noted that market interest rates increased faster than the Federal Reserve increased short term interest rates. Since then, the 10 year Treasury rate has declined from 3.11% to 2.86%. So, the 10 year Treasury has increased 0.52% since that tax code changes became law, while the Federal Reserve has increased rates three times or 0.75%. Therefore, the spread between short term interest rates and longer term interest rates has declined. This is pointing to a flatter yield curve. As a reminder, a flat yield curve would cause earnings problems for banks and therefore a reduction in lending from banks. This is not good for the economy.**
- **With the flattening of the yield curve, there is a mixed result in the bond market.**
    - **The Barclays Aggregate Bond index for intermediate term investment grade bonds was down 1.70% through the second quarter.**
    - **The Lipper Short Term Bond index for short term investment grade bonds was up 0.12% for the first half of the year.**

- **Last year, intermediate term and long term bond yields increased at a slower rate than the FED's rate increases. This was due to lower interest rates in developed Europe and Asia. The Federal Reserve has made clear that they still want to steer interest rates <u>very gradually</u> upward. The good news is that the Fed is confident that the U.S. economy is on solid footing.** Historically, when raising interest rates to combat inflation, the Federal Reserve raises interest rates at a rate of 1% per year.
- **The FED is targeting two more increases in the Federal Funds rate this year given the strength of the economy (four for the year). Employment is available for all who want a job and inflation has hit the Federal Reserve's target of 2%. Assuming that the economic strength holds, there will likely be three more increases of 0.25% in 2019.** This will bring the Federal Funds rate to a range of 3% to 3.25%. As discussed previously, this is a stopping point that is about 1.5% below former targets for interest relative to inflation. This is due to fact that the U.S. economy has grown quite large and the belief that it is not capable of past intermediate and long term economic growth rates.
- **We have made great strides in lowering interest rate risk (going to shorter term bonds) over the last three years. We are beginning to discuss reducing our allocation to lower quality bonds as well, as we <u>may</u> be nudging closer to the end of the business cycle.**
- **Janus Unconstrained Bond Fund disappointment:**
    - **Janus was one of our short term bond fund holdings that had been a very good performer. The fund is managed by Bill Gross (very well-known name in the bond world) and a team of analysts. The goal of the fund is to hold high quality short term bonds with a significant portion of the holdings and have several satellite derivative positions designed to nickel and dime additional return.**
    - **In the 2nd quarter this year the spread in interest rates between the 10 year German Bund and the 10 year U.S. Treasury hit a record. Mr. Gross hedged significant positions that presumed that the spread would decline. The hedges were not in the money when they expired and caused a 6% to 7% decline in the fund. The prospectus allows for a satellite position to be as much as 20% of the portfolio. We had been verbally assured that this would not happen. As a result of this breach of confidence and the knowledge that Mr. Gross intends to maintain this hedge, we have sold out of this fund.**
    - **DBFM has outperformed the bond market each year for longer than the present bull stock market run. The loss in the Janus fund will jeopardize this streak. Generally speaking, we are trailing the weighted bond market index by approximately 0.5%. We are not going to take greater risk in an effort to overcome this loss, but we do hope the elimination of Janus and our stance with the remainder of the bond portfolio will enable us to gain back much of this underperformance of the bond market by year end.**

<u>**Data and Commentary**</u>

- 2016 Real GDP growth: 1.5%
- 1st Quarter 2017 Real GDP growth: final reading was 1.2%.
- 2nd Quarter 2017 Real GDP growth: final reading was raised to 3.1%.
- 3rd Quarter 2017 Real GDP growth: final reading was 3.2%, in spite of the two hurricane punch.
- 4th Quarter 2017 Real GDP growth: third estimate was 2.9%.
- 2017 Real GDP growth: 2.3%.

- 1st Quarter 2018 Real GDP growth: final estimate was 2.2%.
- **2nd Quarter 2018 Real GDP growth: second estimate was 4.2%.**
- **Real GDP growth in 2017 was 2.3%. That is up from 1.5% in 2016. Estimates for 2018 GDP growth are running between 2.9% and 3.3%. Estimates for 2019 center around 2.5%.**
- The IMF also kept the world forecast for real GDP growth at 3.9% for 2018 and 2019.
- **Let us look around the world.**
    - **Eurozone real GDP growth slowed to 1.6% in the 1st quarter and 2nd quarter from 2.5% for the year 2017, the fastest pace in a decade. Their economic expansion is now 21 consecutive quarters long.**
    - **China's real GDP growth in the 1st quarter was equal to the 2017 increase of 6.8%. 2nd quarter growth slipped a notch to 6.7%. The biggest near term issue for China besides the looming trade war with the U.S., is high corporate debt. It is 160% of GDP. For comparison purposes, U.S. corporate debt to GDP is 30.7%.**
    - **Japan's 2nd quarter GDP growth rate recovered to 1% from the disappointing 1st quarter GDP decline of -0.6%. 2017 GDP growth was 1.6%. The decline in the 1st quarter ended the longest growth streak since 1989.**
    - **With stronger growth in the U.S. then Europe and parts of Asia, we are seeing the dollar gain strength and commodities become more expensive. This is a problem for emerging economies that have loans denominated in dollars. This issue has been exacerbated in Argentina and Turkey due to poor fiscal and monetary policies. Emerging market stocks and bonds are in negative territory this year. DBFM does not pursue emerging market investments due to their high volatility and longer term under-performance.**
- Quarterly corporate results are battling trade war worries for headlines. **Earnings growth rate was up a whopping 23.2% in the first quarter and 25% in the second quarter. It appears that Europe wishes to cooperate in reducing tariffs towards zero. Progress is being made with Mexico and Canada with regard to the North American Free Trade Agreement (NAFTA). Negotiations with China over tariffs with respect to business practices (read ownership levels and technology theft) are stuttering at best.**
- **If you use the S&P 500 as your benchmark, we are now in the midst of the longest bull market (without a bear market decline of 20% or greater) in the history (back to 1850) of the USA. 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 still 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. There are concerns that the 2018 tax law changes may add too much fuel to the economy. Inflation has touched on the FED's target of 2% in June and July.**
    - **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 of the dangerous years of 1929 or 2000. Since this bull**

market began, individual investors pulled money from stock mutual funds every year until the last two years. The inflow in 2016 and 2017 has not been exceptional by any means. We would estimate we had been entering the optimism phase. Corporate news is strong, but uncertainty regarding trade policy has put a damper on optimism.

- **Speculative valuations are present in some well-known growth stocks as well as some young biomedical companies. Growth stocks as a whole are significantly overvalued. Overall market speculative valuations certainly are not present as they were in the late 1990's.**
- **Geopolitical shock: North Korea. Middle East. Italy (potential to leave the EU?). Keep an eye on trade policy. As discussed above, China trade war risk seems to be the main reason for concern.**
- **Oncoming recession (?):**
    - **Not in view at this point.**
    - **Although, earliest prognostications of recession are for late 2019. The basis of this prediction is an inverted Treasury bond yield curve caused by Federal Reserve short term bond interest rate increases and lower yields in Europe and Asia holding down intermediate and long term bond rates. The Federal Reserve has expressed caution with regarding to inverting the yield curve. This will certainly be forefront in their deliberations regarding increases in the Federal Funds rate.**
    - **We are still in a rare period of simultaneous worldwide economic growth. Recessions normally are the byproduct of excessive imbalances. Because of the slow growth since the Great Recession, they have been slow to materialize (other than some growth stocks).**

- **Economic Indicators vs. Geopolitical News: The U.S. economy continues to show significant strength. In the rest of the world (minus some notable exceptions with Turkey, Argentina, and Venezuela), the first quarter economic speed bump appears to have been just that. Subsequent to the 2nd quarter end economic indicators are winning the day over geopolitical news.**
    - **The U.S. economy was unusually strong in the second quarter with a 4.2% annualized gain in GDP. With strong corporate earnings gains in the 2nd quarter and progress in trade negotiations with the E.U., Mexico, and Canada since the 2nd quarter end, the stock market has gains of nearly 5% for an all stock portfolio.**
    - **China trade negotiations, North Korean on-again – off-again negotiations, Iran sanctions, Middle East unrest, Italy political uncertainty with regard to leaving the E.U., and Brexit negotiations all seem to have quieted down in comparison to economic gains in the U.S.**
    - **Leading economic indicators are up 7.2% through Q2 as compared to 2017.**
    - **Housing data can be volatile, but existing home sales and housing starts are beginning to look like they have peaked out in the first quarter this year.** 2nd quarter existing home sales declined 1.7% from the 1st quarter, from 5,507,000 homes down to 5,413,333 homes. Supply of homes for sale remains at a depressed level of 4.3 months. Six months is considered a balanced supply of homes for sale. Housing starts rose 11% through May, but declined 12.9% in June (1,158,000 starts) from May (1,329,000**). Forward looking information is mixed. Building permits declined from 1,355,333 in Q1 to 1,319,000 in Q2 or down 2.7%. But, household formation has jumped to an annualized rate of 1.76 million in 2018 from just shy of 1**

million in 2017. We would estimate that limited housing supply, construction labor shortage, rising prices, and higher mortgage rates will keep a lid on housing.

- **New orders for durable goods (annualized) are up 6.4% over 2017 through Q2 this year.**
- **Consumer spending is up 2% from 2017 year end through Q2 this year.**
- Consumer confidence has been gradually trending up since July 2007. **The consumer confidence reading hit a 17 year high in October at 125.9. Fast forward to August this year the reading is 133.4. This is the highest reading since October 2000.**
- **The Personal Savings Rate: Hmmm…the Bureau of Economic Analysis recently revised their analysis of the personal savings rate in the U.S. They indicate that they had been leaving out dividends, interest, and business owner's profits. The personal savings rate in June was 6.8%. It appears that the U.S. has been saving near this rate since 2010. The recent low point was 2.4% in 2006. This revelation of a higher savings rate is not likely to change the prospects for our economy given that it has always been present, just not measured.**
- **Business investment remains at elevated levels in the 2nd quarter this year. The annualized level is in excess of $595 Billion. This is nice, but in addition corporations are expected to apply $800 Billion to stock buybacks and $500 Billion to paying dividends.** Business investment in capital leads to higher levels of productivity, employment, output, and income.
- **Institute of Supply Management continues to be strong: Readings above 50 mean growth.** Readings above 60 are rare.
    - Institute of Supply Management – **Manufacturing (12% of the U.S. economy): 58.1 was the reading in July. The August reading was 61.3 (14 year high).** Manufacturing has been on a strong up-trend for the last 27 months.
    - Institute of Supply Management – **Service (80% of the U.S. economy): The June reading was 59.1. July was 55.7.** Readings have been above 50 since early 2010.
- **Employment**
    - **Monthly hiring remains strong:** 2016 average was 180,300. 2017 average was 170,500. The average for the first seven months of 2018 is 190,200.
    - **The four week moving average for unemployment claims has declined further to 212,250. This is the lowest reading since December 1969. This reading has been below 300,000 for 182 weeks in a row. Readings below 300,000 point to continued substantial monthly hiring.**
    - **A review of the unemployment, underemployment, and the labor force participation rate indicates that we are 3.1% away from full employment. Presently, there is more than one job opening for every officially unemployed person in the U.S.**
- **Financial Stress Index is very low (lack of stress).** The average reading this year is a negative 1.153. 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. The dollar reached a recent low point on 1/25/18; it was down 12% since the end of 2016. The dollar is now up 3.4% for this year. It is still down 6.9% since the end of 2016.** This is not an impactful move at this point except for emerging market debt issued in dollars.

Summary / Additional Comments

- Trade war risk seems greatly reduced in just the past month. The European Union wishes to negotiate towards zero tariffs. Mexico and the U.S. have agreed to terms on an update to NAFTA (North American Free Trade Agreement). Canada is signaling a desire to complete a three way deal to update NAFTA. China is dragging their feet, but there appears to be some movement afoot to achieve an agreement before the President XI Jinping visits in November.
- Economically, the positives significantly outweigh the negatives. Leading economic indicator trends are strong.
- The housing market may be peaking, not from a lack of demand, but rather from a limited supply and rising prices.
- We will keep an eye on rising inflation. Inflation has the Federal Reserve's target of 2% for the last two months.
- The employment participation rate is increasing and the under-employment rate is falling. Theoretically, unemployment is high enough that there are just enough people to fill job openings.
- Labor shortages are problematic in many industries and communities. Birth rates continue to decline. Labor supply will eventually constrain economic growth in the U.S. unless proactive steps in the area of training and immigration are taken.
- Absent geopolitical risks, one can envision an even longer extended period of economic growth. Q2 GDP growth of 4.2% may have been the peak. It is very difficult to ascertain where the U.S. stands in the business cycle. Over the last few years, we have experienced movement back up the business cycle curve (improvement). Although, a limited supply of labor, higher inflation, an inverted yield curve, or trade war could be tipping points for a downturn, all are conceivable but none are imminent.
- We remain focused on the long view of value investing and seeking income as well as long term appreciation of investments. Our focus on the status of the economy is not directed at seeking market exit and entry points. Rather, it is intended to help us target potential tactical adjustments to portfolios.
- While we are monitoring the economy and the risks to equity and bond markets, periods of decline are unavoidable. Nothing can replace the decisions / choices you make with regard to growing your wealth over the long term.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

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