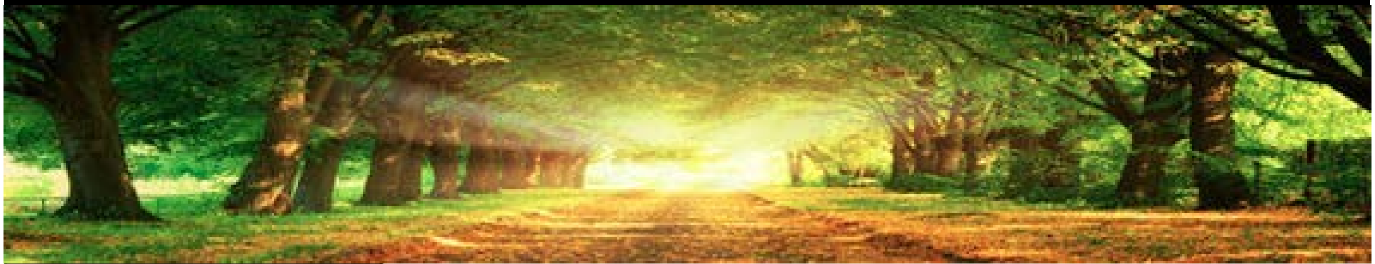
MAY 16, 2017



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Market Update

As of Mid May we are still below the **Dow Industrial's** March intraday high of 21,169. Volatility still remains low however there is a large amount of sector dispersion. The retail sector featuring companies such as Macy's, Target, Nordstrom, Kohl's, etc. has performed extremely poorly while technology featuring companies such as Apple has continued heading higher. This correction, while still unfolding, should in my opinion mirror in time and depth the correction from April-June 2016 which was roughly 6%. If this correction unfolds as I suspect we could then make a move to new highs after completion.

The U.S. dollar Index made its high back on January 3rd. The dollar has been in a sideways consolidation since that point that looks like it may have completed on March 27th. The correction has extended in duration but not in depth. It seems that a resumption of the dollar uptrend that leads it above the January high over the next few months could occur.

The U.S. Treasury bond market seems to be embarking on a multi-year interest rate rise. Remember, when rates rise, bond prices fall. If one chooses to own bonds at this point it is purely for diversification purposes as the income earned from Treasuries is virtually non-existent at this point.

The Gold and silver correction from last summer appears to have run its course. Gold bottomed back in December at $1,122.98 an oz. in the spot market. Since that point, they have been rallying in a stair step pattern…2 steps forward, one step back. Each step back has ended at an equal or higher level which is generally an upward moving trend line. I continue to believe this is just the beginning of a much larger trend through 2018. This current rally in my opinion should head above last August levels toward $1,450 oz. before starting a period of consolidation.

In a move that is surprising to many, **Foreign stocks** have rebounded substantially since their U.S. election related correction, and are generally now trading higher than on election day. After an uneventful French election, Europe has taken another leg higher, followed by the emerging markets.

Risk Taking and Risk Management

The business of investing is all about assessing and taking risk. Liquidity risk, interest rate risk, loss of principal risk and opportunity risk are four that come to mind immediately. Through its low interest rate policy, the Federal Reserve and governments around the world in the developed economies have made it explicitly clear….you will not earn returns on money if you are unwilling to take risk. We have been pushed to take some sort of risk. Even remaining in cash or cash equivalents has risk. Earning less than 1% when your cost of living is increasing means you are actually losing purchasing power. The reason to keep cash on hand is definitely not to make interest. Having cash provides you with options. Keeping money in cash is implicitly saying you think better opportunities will be afforded at some point in the future.

I think one of the most important questions long term investors need to ask is how much risk with their investments they are prepared to take. If you are prepared to take more risks, you should generally expect to potentially earn higher returns IN THE LONG RUN. Of course, anything can happen in shorter time periods. But taking on too much risk can lead to disaster as well.

None of my clients were alive in 1929. But, if you were alive, and you were an investor and you put 60% of your money into the S&P 500 index and 40% of your money into Treasury Bonds in September, 1929 you only had 39% of your capital left in 1932. If you put 100% of your money into the S&P 500, you only had 18% of your money remaining three years later! Of course 1929-1932 was the worst period for the U.S. Market in our history and is not an average investor's experience. Can you imagine if you retired in 1929 after the roaring 20s with a nice, fat nest egg and that happened? There were many where it did happen.

Determining how much risk YOU can take is an extremely important exercise to go through with your financial advisor. There are two primary aspects to risk:

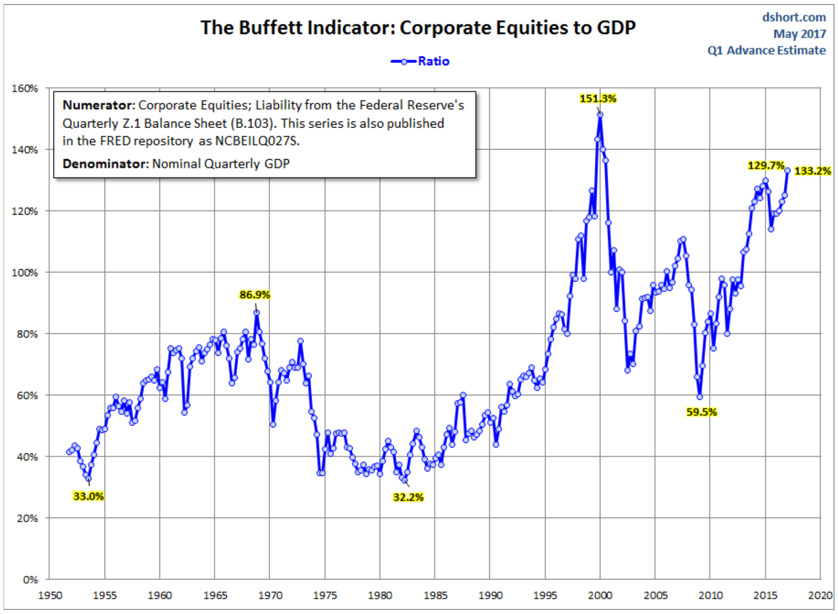
1. Risk Capacity: The extent of loss a person or family or organization can handle without having to significantly change spending patterns
2. Risk Appetite: This is what most questionnaires measure. Having a longer time horizon and an emotional ability to withstand market volatility determines one's risk appetite

They are related when doing investment planning and it is important to determine where you lie according to both. Someone may have a large risk appetite but financially may not be in a position to take on large risks. Conversely, someone may be extremely well-off but emotionally may not be willing to expose their portfolios to volatility risk. Recognizing and understanding your situation can give you a lot more confidence when allocating your assets. If you would like to further analyze your risk capacity and risk tolerance feel free to email us or give us a call.

What Could Go Wrong?

As an investment and financial advisor I typically start of every potential idea assessing what could go wrong? By assessing the risks to an investment or strategy it makes it easier for me to either accept the risk, hedge the risk, transfer the risk or avoid the risk. I can then go about making a suitable recommendation.

When looking at the U.S. stock market I continue to believe the largest risk is the extremely high market valuations. In fact, by many measures, the 2017 U.S. stock market is sporting the third highest valuation measures ever! Based upon ratios such as price to sales, price to book value, price to GDP and Shiller's price to earnings ratio, this U.S. stock market is very expensive. However, it has been explained away by Wall Street as being fairly valued because of the extremely low interest rates and "lack" of competing investment options. While on the surface this idea has merit, a few investment firms have done research and found little to no correlation over time to low interest rates and persistent high valuations. In fact, many times, low interest rates have coincided with low valuations because of an anemic economy. Here is a chart of Warren Buffet's favorite measure of valuation and where it currently stands…



While valuations are a very poor short term timing indicator, they give you an idea of what sort of value you are receiving for investing a dollar in the U.S. stock market. Suffice it to say, while there are always opportunities within the stock market, the overall market is very expensive. We can argue over how expensive it is but the bottom line is that when markets get to these valuation levels, results have not been positive. Caution is warranted.

However, take a look at this chart. Some of you have already seen this chart put together by Henderson. This shows the comparison between U.S. markets, Europe, U.K., Japan, and emerging markets. What you see is a ratio that has become extreme. Valuations in Europe, the U.K. and the emerging markets are about half of those here in the U.S. Now that is because of 6 years of underperformance compared to the United States. That has set the stage for potential outperformance by those markets compared to the United States. **In my opinion, when investing for the next 5-7 years, the much better risk/reward is by investing in foreign stock markets.**

International valuations

US vs EAFE equities, relative price performance (USD)

	US	Europe ex-UK	UK	Japan	Emerging Markets
Shiller P/E	24.6	16.9	13.6	23.8	13.5
Long term median	19.8	18.8	14.5	37.7	15.8
Premium / Discount	**24%**	**-10%**	**-6%**	**-37%**	**-15%**

Source: Thomson Datastream, MSCI, Henderson as of 12/31/2016. Shiller (cycle-adjusted) P/E's are inflation-adjusted price-to-earnings ratios that measure the price of a stock (or index) to it's average EPS over the past 10 years. The chart above is illustrating the relative valuation of the European and US equity markets. Currently European markets are trading at a discount to US markets and this discount is significant because its more than one standard deviation outside the mean. Standard deviation measures the dispersion of a set of data from its mean. Long-term median measures the median index value since inception of the index.

Henderson GLOBAL INVESTORS

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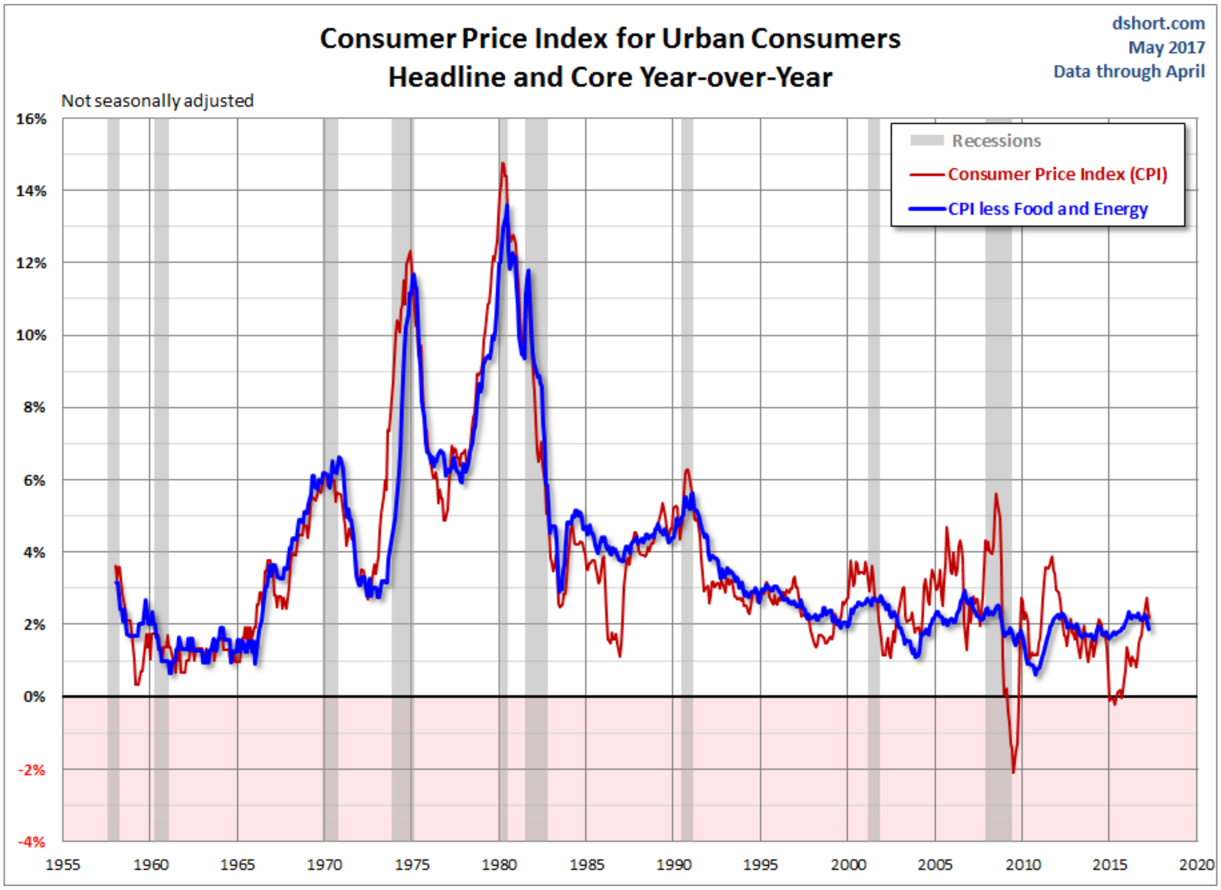
Potential Catalysts?

Elevated valuations mean nothing without a catalyst. As is often said, valuations don't matter until they do. Back in 1996, the U.S. market became overvalued, but it took another four years before a catalyst emerged. In my opinion, **THE significant risk that is underappreciated is an inflation event and the higher interest rates that would accompany it.** Inflation, as you can see in the chart below has been slowly rising since it was at zero in early 2015.



Stocks tend to perform poorly during periods of elevated inflation. The last serious event in the U.S. was in the 1970s. U.S. stocks made no money from 1964-1981. The cash flows from the businesses hold up well and often rise but stock prices generally decline as valuations (P/Es fall). Treasury Bonds often perform horribly in that type of environment since they pay out fixed rates in a rising rate world. However, if one does need to hold bonds, investing in TIPS (Treasury Inflation Protected bonds) can potentially make a lot of sense depending on your individual objectives and other suitability factors. Not to say that TIPS would do well in inflation because rates would most likely still rise, but TIPS would most likely outperform conventional bonds if an inflation event occurred. However, they would likely underperform in the event there was a severe recession or depression. Assets that typically do well in periods of rising inflation include precious metals and other types of alternative investments. If potential inflation is a concern for you, don't hesitate to email or call us in order to assess its potential impact on your portfolio.

Ever since I came into this business, I was taught that the four most dangerous words were, *"This time is different."* History has a way of repeating itself. Life and markets often move in cycles. I think an important part of investing capital is understanding where markets are in the cycle.

Investment Ideas

- **Rather than trying to "beat the market", focus on beating inflation and the rate on cash. Plan for safety and liquidity while seeking positive returns.**
- Equity valuations are very rich but masked due to the distortion of the Treasury curve. Volatility is returning to the markets and I think long/short managers are best positioned to capture this volatility by owning companies with strong businesses, barriers to entry, and good valuations and selling short weaker companies with high debt loads that have risen sharply with the broad market rally. I think this strategy of hedged equity may have the potential to produce attractive risk-adjusted returns if and when investors begin to question the valuations of companies. Stock investing involves risk including loss of principal. No strategy ensures success or protects against a loss. Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

- Monsoon country investments. Attempting to take advantage of demographic, educational and investment possibilities in the countries surrounding the old spice routes of the Indian Ocean. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

- In 2013, the Affordable Care Act began implementation. There will be many winners and losers in the healthcare industry as a result of the biggest change in the healthcare industry's history and what the new administration decides to do with it. With the largest portion of the U.S. population entering their golden years, healthcare needs will become even more important. Long/short Healthcare seems to be a very attractive way to invest in a sector with lots of potential and lots of potential pitfalls. Investing in a specific sector involves additional risk and will be subject to greater volatility than investing more broadly.

- A potential U.S. infrastructure upgrade cycle may be around the corner. Moving from our current grade of D+ to B would require an investment of $3.6 trillion by 2020.

- Supply problems remain high across the energy asset class. While there isn't a current shortage of energy on the planet, it is taking more and more energy and capital to discover, drill, transport and refine it. Long term Demand should continue to grow globally, particularly in China, India, and other developing countries.

- Potential food shortages due to inclement weather and higher demand from the emerging Asian middle class could result in a boon to agricultural land and potash fertilizer companies. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

- The rise of E-Commerce has coincided with an increased desire for efficient warehouse distribution real estate. As e-commerce moves toward even faster delivery, positioning of distribution becomes even more important.

- Precious metals mining companies have been extremely beaten down over the past four years but have begun rising. Mining is an industry that spans hundreds of years. Companies that mine for commodities are often highly cyclical, meaning they have sustained moves both up and down. When investing in the mining space it is important to be a contrarian. Ideally, you would want to accumulate miners when sentiment is poor around them and sell them when sentiment is positive. Historically this has been a good strategy.

  No strategy ensures success or protects against a loss.

MAY 16, 2017

Regards,

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