945 Technology Blvd., Suite #102, Bozeman, MT 59718

QUARTERLY NEWSLETTER

2017 Second Quarter

Dear Client,

We hope things are well with you and your families.   As we did last quarter, we are sending you our quarterly communication by email and we hope you find this format agreeable. This also serves to let you know that your 2nd Quarter performance report and invoice have been mailed so please be watching for this information.

As a reminder, please make sure you are receiving statements (paper or electronic) from all your current account custodians. Also, please compare these statements to your PFM quarterly report (note that there might be slight discrepancies due to the timing of the credit of dividends or transactions at quarter end). Please let us know about any material differences so we can address them immediately.

We research and read numerous financial planning and investment related articles each month with the intent of sharing the most relevant topics with you in this letter. I was prepared to share some relevant information on a retirement planning topic (how much is enough for retirement – coming in a future communication). However, recent media attention directed at high US market valuations and concerns of a coming correction compelled me to switch gears. This is a topic discussed in this letter two years ago and since then, despite a couple of short-lived setbacks, markets have extended their historic bull market run. Media coverage has heightened concerns of investors, again making this a relevant issue to re-visit and address. Before doing so, however, here is a quick rundown on how global equity and bond markets fared both this past quarter and through the first half of 2017.

SECOND QUARTER 2017 IN REVIEW

Though the headlines might have investors thinking the contrary, the majority of the world's financial markets ended the first half of 2017 with impressive results. While the overall US market did well, International and Emerging market equities reversed the trend of US market dominance (see benefits of diversification in our previous letter) generating impressive returns through the first half of 2017. On

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the bond front, US markets were positive despite another measure of interest rate tightening from the Fed. International Bonds also were positive despite the ECB's continued easy monetary policy.

The apparent revival of European markets is welcome news on the global economic front. Europe appears to be climbing out of the "doldrums" as Eurozone GDP (Gross Domestic Product) grew faster than US GDP for the first time since 2008, with year over year growth at 1.8% through the first quarter of this year. With a projection of slow but steady growth, results may be even better for 2017.

The first half of the year saw a reversal of trend in the performance of Value and Small cap stocks from their 2016 dominance. Value underperformed growth in the US, International Developed, and Emerging markets. Small caps outperformed in Large caps in International Developed markets but underperformed in the US and Emerging markets. A summary of QTD and YTD performance is as follows (more detailed information can be found on the website):

	US Stock Mkt.	International Dev. Mkts	Emerging Mkts	US Real Est.	US Bond Mkt.	Global Bond–ex US
Q2 '17	3.02%	5.63%	6.27%	1.78%	1.45%	.60%
YTD '17	8.93%	12.82%	18.43%	1.82%	2.27	.24%

Source: Russell, MSCI, Wilshire, Barclays and Citigroup

VALUATION, MARKET CORRECTION, AND INVESTOR UNCERTAINTY

The US bull market run (defined as a rise in prices without a 20% decline, or bear market) turned 8 years old in March and is 100 months as of the writing of this letter. The most surprising element about market returns to date is not so much about the broad market gain (which could be attributed to an economy that is making strides) as it is about the overly bullish sentiment. Despite domestic and geo-political headwinds, the US market has continued its push to record heights in 2017 and done so with a surprisingly low level of volatility. A colleague shared some meaningful data with me that the S&P 500 has now achieved the 5th longest streak in its history without a 5% decline. Also, according to the VIX or Volatility Index, nine of its lowest closes throughout its 30-year history have occurred in 2017, representing one of the lowest drawdown periods in history.

The result: a record setting market valuation number that garners a great deal of attention from the financial media which in turn, fuels investor concerns. The CAPE ratio (Cyclically Adjusted Price Earnings Ratio) developed by 2014 Nobel Prize winner Prof. Robert Shiller, is the most widely recognized measure of this market valuation and the historical average of the CAPE which utilizes data going back to the late 1800's, is around 16. As of the writing of the letter, the CAPE is almost at 30, a level only experienced two other times in history (1999 and 1929).

What does this information mean?

Right now, I don't think you will find anyone who will disagree with the notion that the US market is expensive at current levels. While a drawdown event is probable at some juncture, expensive markets on their own can't cause a market correction – there are other factors or variables involved. First, no two Bull market cycles are alike, and can vary based on the economic environment present during that time (i.e., interest rates, inflation, corporate earnings, etc.). Second, a market metric like the CAPE is not perfect, and though it provides us valuable information, it does have shortcomings. Consideration of these elements could lead to a conclusion that markets may not be as expensive as feared or on the

verge of correction….at least not right away! With this context, here are some points to consider (not in order of importance!):

- <u>Use of the CAPE Ratio</u>: The CAPE was designed to gauge/forecast future market returns and even Professor Shiller himself has stated recently that it is not an appropriate market timing or investment making decision tool. True, high market valuations are an indicator of lower future returns, but they are not necessarily a predictor of a correction. No one knows how long we could stay in an overvalued state. An example we bring to light with clients when this issue arises is that Alan Greenspan deemed markets overvalued in his famous 1996 irrational exuberance speech, yet they continued to move straight up from there (also, when the correction came, markets never re-treated back to the level).
- <u>Methodology of the CAPE Ratio</u>: The stock market and the world in general have greatly changed over the almost 150 years of data tracking. In fact, the CAPE from 1980 to now has rarely been under 20. Even Prof. Shiller feels that the fair value (the value that would project "normal" long term future stock market returns) is possibly much higher than the historical average of 16.
- <u>Strong corporate earnings growth</u>: According to Bloomberg, S&P 500 companies reported Q1'17 earnings of almost 15% year-over-year. This growth is expected to continue through the second quarter and companies are optimistic. I did read an article recently making a plausible argument that the strong earnings of current periods will gradually replace those very low earning periods of the Great Recession (included in the current 10-year calculation) thereby bringing the CAPE ratio down – interesting thought.
- <u>Low Interest Rates</u>: The low rate environment makes stocks a much more attractive investment option. Since future bond returns can be predicted with some certainty, the (paltry) interest rate being paid on long term bonds, stocks almost assuredly will have a better *average* return than bonds, even with short-term corrections accounted for.

Here is something else to consider. A market doesn't necessarily have to have a price correction. Markets can also correct in time. The latter means that markets essentially could be flat or sideways for a time, giving earnings a chance to catch-up. Many market strategists have suggested this could be a likely scenario based on where inflation is today and the strength of forward looking corporate earnings.

What this means to you and your portfolio.
So where are we going from here? Again, there is no disputing the market is overvalued, but the reasoning that valuations may not be as high as thought or that the market may have room to run based on other economic factors, still doesn't necessarily calm investor's jitters. It is said markets "climb a wall of worry" and as markets climb higher, investors will continue to be concerned about when the "other shoe is going to drop", whether it be in a few weeks, a month, or even a year from now.

While we can make the inference that high valuation indicates lower future returns (market prices eventually revert to their mean), we have no way of knowing what these might be or even when this will occur. All credible arguments aside, market valuation, like any other market related or economic concern has no specific "investor fix". Thus, if you listen to the market pundits long enough, you will realize they know nothing more than you, and in the end, there are no telltale signals for investors to buy, hold, or sell during times of stress – they don't exist. Uncertainty and investing go hand- in-hand, and in times of uncertainty, emotions tend to take over and become the enemy of one's portfolio.

So is there no hope…nothing an investor can do? Not quite – investors do have a remedy if they take the time to assess their financial situation. At the risk of sounding like a broken record, it is our job to keep reminding clients that the only way to take the sting out of market uncertainty is the development of a long-term rules based investment plan. The good news is that you have one in place! Every client of PFM has an academically researched investment plan that:

- Considers a proper allocation to both risky (stocks) and less risky (bonds) assets;
- Spreads risk across different asset classes of stock and bonds across the globe;
- Emphasizes those areas of the market that tend to have the best success long-term; and
- Re-balances on a regular basis.

This strategy alleviates the need for you to "do something" every time the market "zigs" or "zags". While no investment plan is perfect or can alleviate all the pains associated with investing, a properly designed strategy can help shoulder concerns and take the stress out of uncertain investment environments, all while helping you achieve the best possible long-term results.

Remember, proper planning and any changes to a plan should be centered on what is going on with your personal situation, not what is going on in the markets or world at large. With this in mind, we are constantly reviewing client portfolios and updating client allocations to be commensurate with current and future goals and plans. If we have not gotten to you yet, we will be in touch, and if you have not heard from us but have concerns, we encourage you to call or email.

We have some other supporting articles and literature we will be sending to you in the near future relating to market uncertainty. In the meantime, I hope this information helps not only to put current market conditions in perspective, but also provide any needed re-assurance. My final thought to you here is this: As a long-term investor, be concerned, but don't be fearful!

As always, thank-you for your trust and the privilege to serve as your financial advisor. Please enjoy the rest of your summer!

Sincerely,

Doug Babcock, CFP®