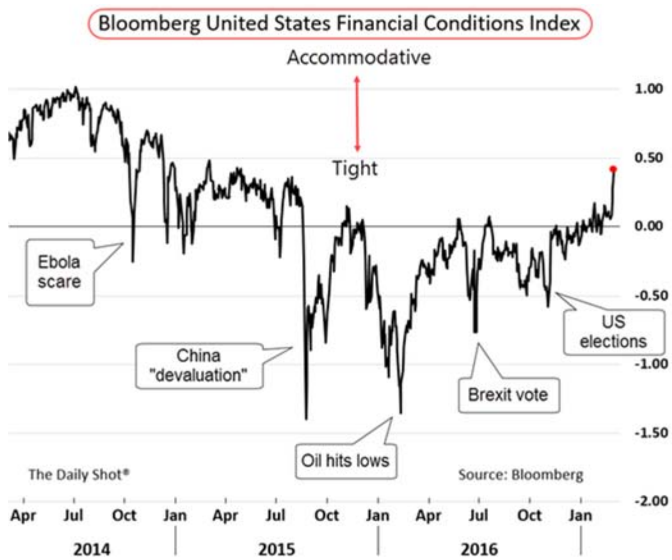
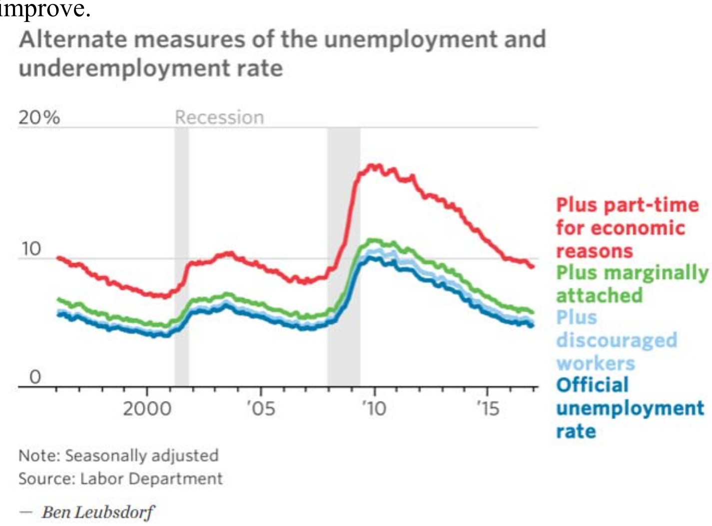
First Quarter 2017 Commentary

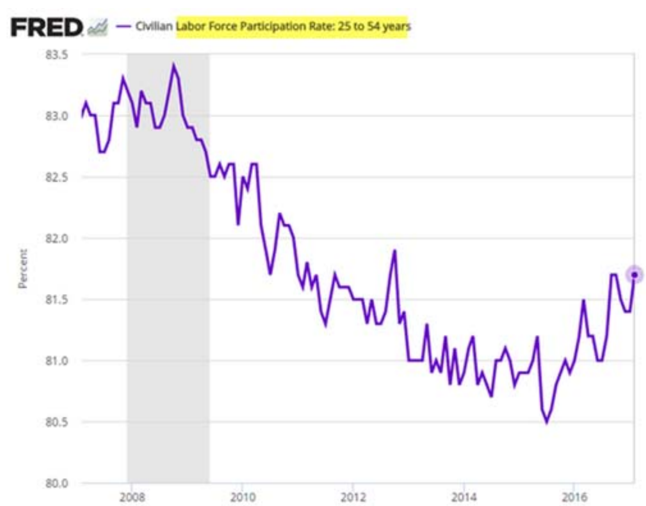
Setting aside the distraction of the day, there was much to analyze, assess and observe with the economy and financial markets in the first quarter of 2017.

Fortunately for most Americans, the economy continues to grow. As a whole, we are experiencing 2% to 2.5% growth in Gross Domestic Product. Furthermore, we are experiencing some inflation, but not too much inflation. The combination of these together reflects an economic landscape that is healthy and expanding.

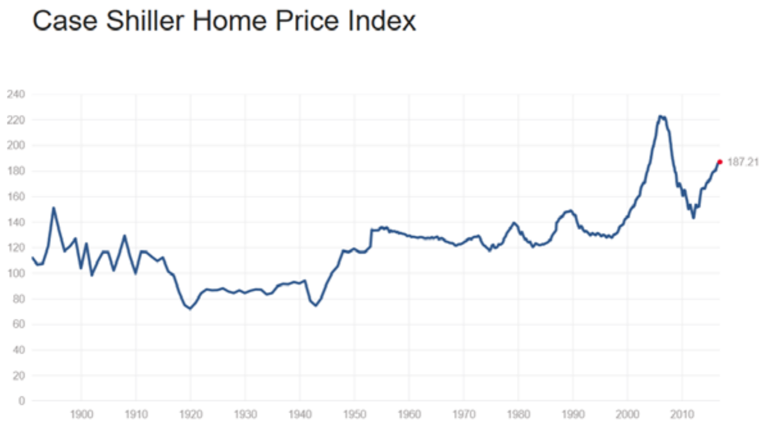


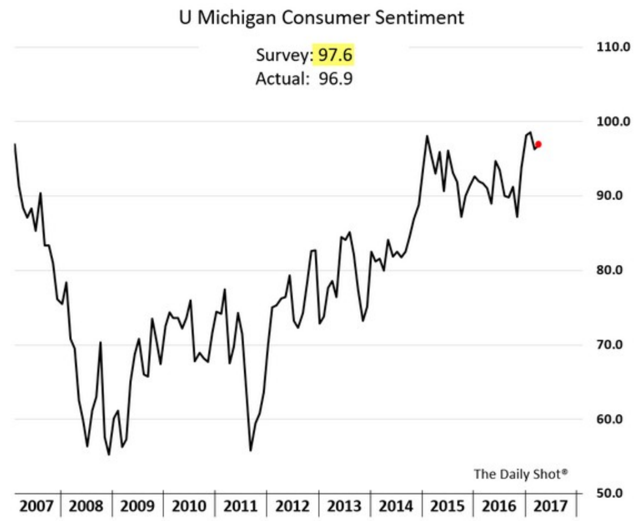
Along with an expanding economy has been a reduction in unemployment. As we have discussed in past commentaries, the "official" unemployment figure of 4.7% does not tell the full story. However, as can be seen in the chart below, all categories of unemployment continue to improve. More importantly, the Labor Participation Rate of those who are in their prime earning years continues to improve.

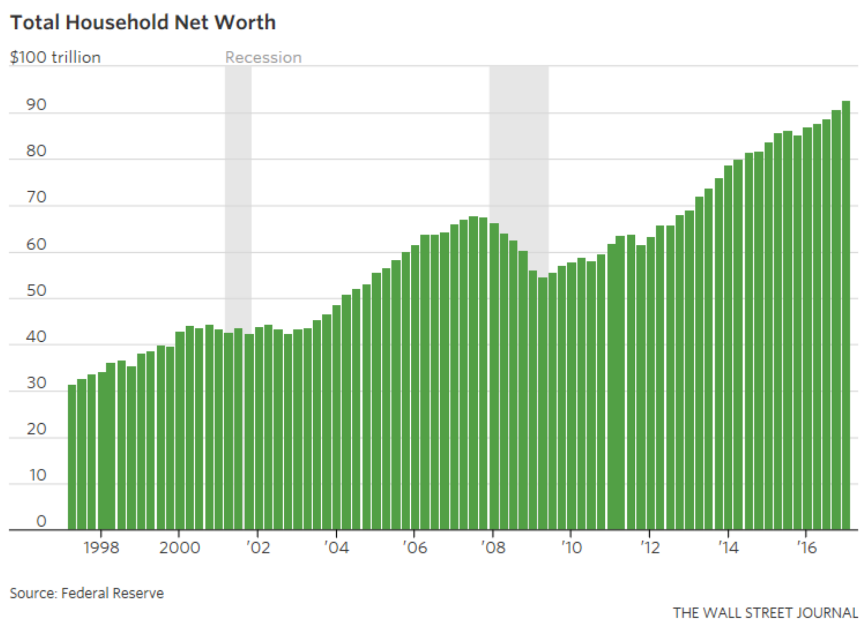




Increased employment, stable and increasing housing prices and an improving stock market have increased total household net worth to record levels. The Consumer Sentiment Index is at 97.6, well above the long-term average of 85. When the average consumer is positive, they tend to spend more.

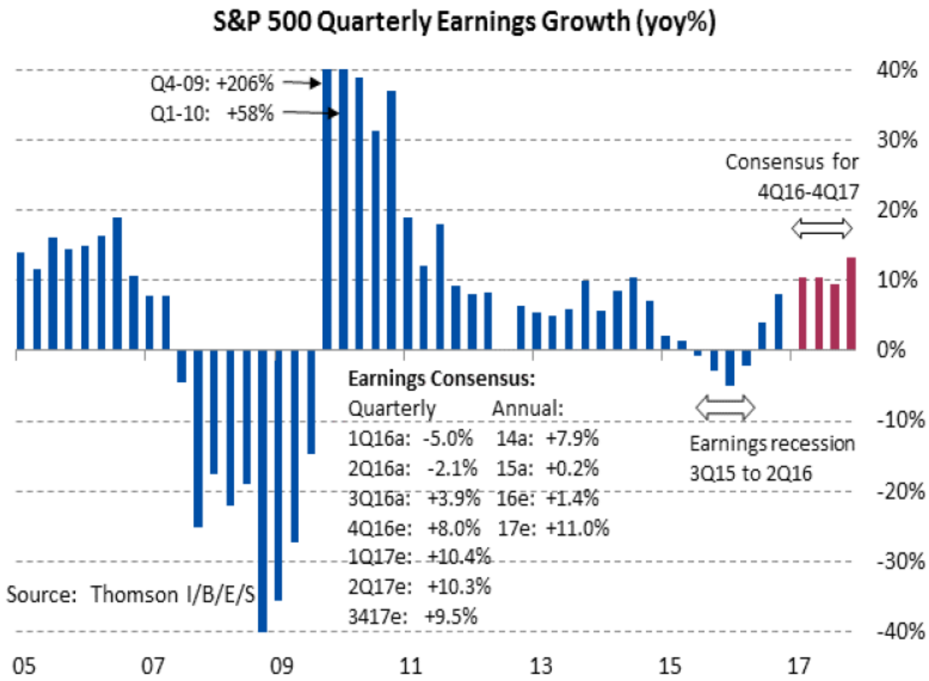






The Federal Reserve raised short-term interest rates at their March meeting. We anticipate the Fed will increase short rates two more times this year. Along with an economy that is healing, this starts the long climb to return interest rates to a level that could be considered "normal." In doing so, rate increases do not appear positioned to stifle the stock market and yet fixed income investors may have some hope of earning interest income yet once again.

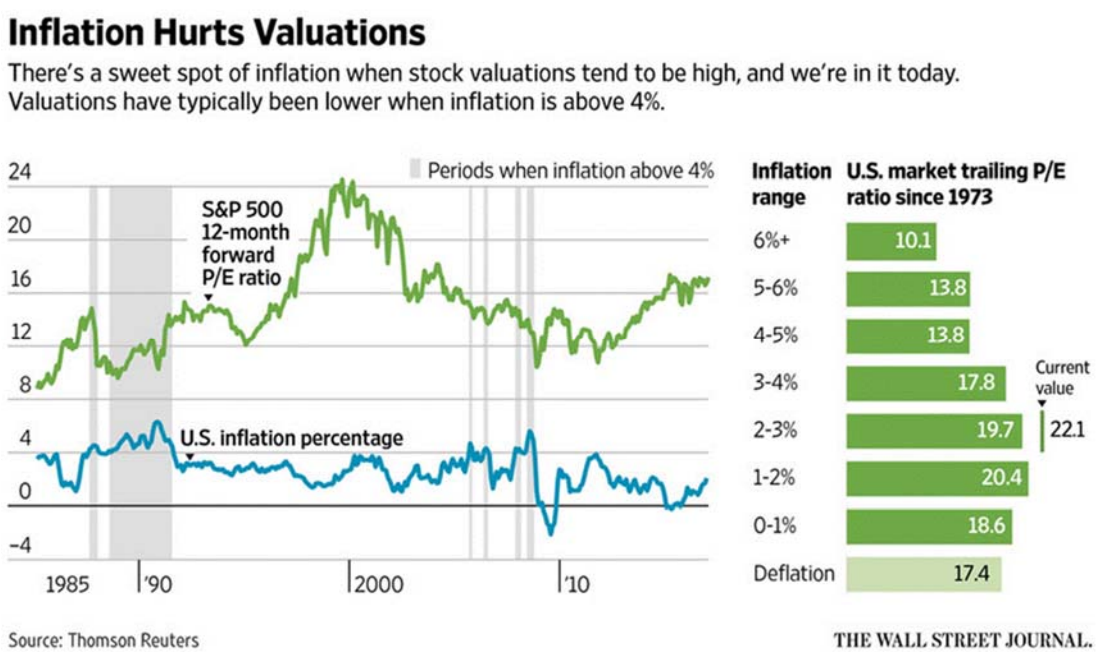
After experiencing a decline in corporate earnings from the second half of 2014 into the beginning of 2016, profits are improving. This has not only helped to buoy the stock market, but to expand inventories and employment.



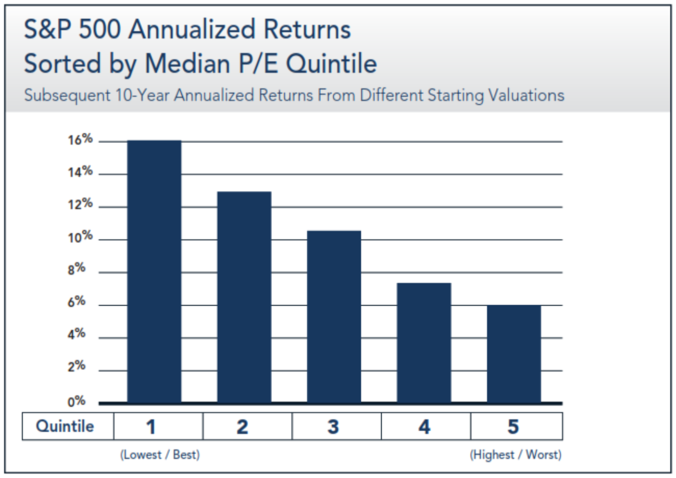
With the run-up in the stock market, valuations are on the high-side—however, not as expensive as they first appear. At 26 times earnings, the S&P 500 is expensive. However, referring back to the previous chart, the Price to Earnings ratio is reflecting earnings levels from 12 months ago. At that time we were in the midst of an “earnings recession.”

More importantly, going forward the Price to Earnings Ratio of the market is 17. That is still an expensive level, however, it is not a nosebleed type of valuation.

Furthermore, interest rates and inflation both remain low. Historically, the 10 Year US Treasury Bond yields about 5% whereas today that yield is 2.36%. Similarly, inflation below 4% is generally favorable. Today, we are at 2%. Given this, on a comparative basis investors can justify paying more for stock market assets.



Referencing the chart below, we are currently in the 5th Quintile of valuation. If nothing were to change, we would expect returns over the next 10 years to be muted compared to historical averages.



18.8%	17.0%	14.2%	12.5%	9.8%	Maximum 10-Year Annualized Return
12.4%	10.1%	2.6%	1.9%	-0.5%	Minimum 10-Year Annualized Return
1	**2**	**3**	**4**	**5**	**Quintiles**

Source: CMG Investment Research, Ned Davis Research Median P/E Data 1981 – December 2015

Remember that the financial markets are a discounting mechanism. They discount, or anticipate, what will happen in the future. Some of the things that are anticipated, but yet to be proven are:

1) **A rebound in earnings**. Remember that much of the world stock markets were in an “earnings recession” from 2014 into 2016. As such, any of the financial metrics that are based upon the “Trailing Twelve Months” will be significantly handicapped. A mere rebound in earnings will change the optics of how these calculations look. Corporate earnings are expected to increase 9% in the next year—the best year over year growth rate since 2011.
2) **Corporate tax reform**. The United States has the highest corporate tax rate in the developed world at 35%. Countries such as England and Ireland are a modest 8% or 10% tax rate. This encourages capital and profits to stay outside the U.S. Merely lowering our corporate tax rate to 20% or 25% would greatly encourage capital to be repatriated back into the U.S.
3) **Individual tax reform**. Trump’s tax proposals feature a lowering of individual taxes from a high of 43% to 33%. This would possibly succeed in allowing the average citizen to have more “net of tax” spending money.
4) **Health-care reform**. Healthcare offerings under the Affordable Care Act is simply not affordable. The quality and amount of healthcare offered under this plan costs more and delivers less. Any reform that would offer flexibility on deductibles and coverage would go a long way towards helping the average American.
5) **Regulation reform**. Over the last 20 years (not just 8) the world has become increasingly complicated. In reaction, the government (Federal, State and Local) has repeatedly implemented a variety of regulations. Simply having government that does not believe that more regulation is the solution could potentially be a huge tail wind to the economy.
6) **Favorable interest rates**. Most of the comparative financial metrics use interest rates that were more in the range of 5% on the 10-Year US Treasury. We are half that today. Furthermore, although rates are increasing, they remain very attractive on a relative basis. This supports elevated equity valuations and makes equities look more attractive from an opportunity cost perspective.

Hopefully, some of these measures will be implemented that should help our economy on a variety of levels.

Sincerely yours,

Dave *Warren*

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™

Warren Udd, Vice President
CERTIFIED FINANCIAL PLANNER™