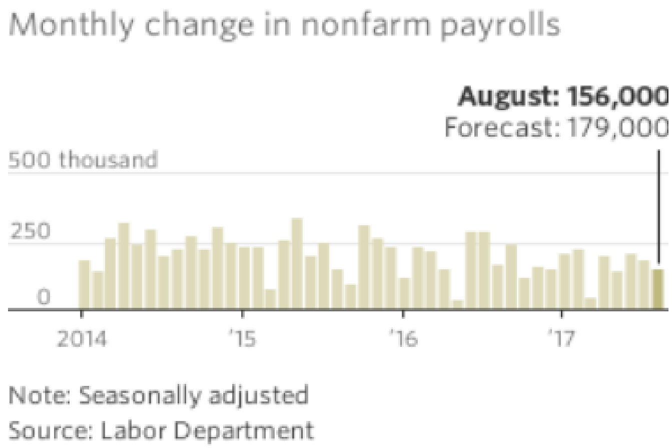
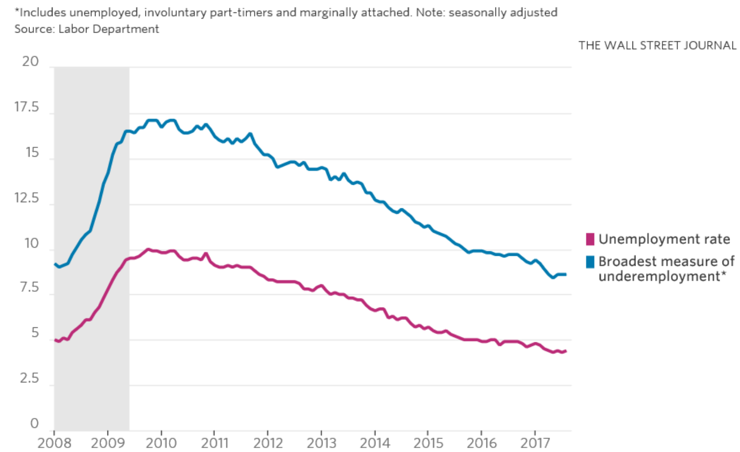
Sather Financial Group, Inc.

Private Wealth Management

Third Quarter 2017 Commentary
<u>Recovering From Hurricanes & Floods</u>

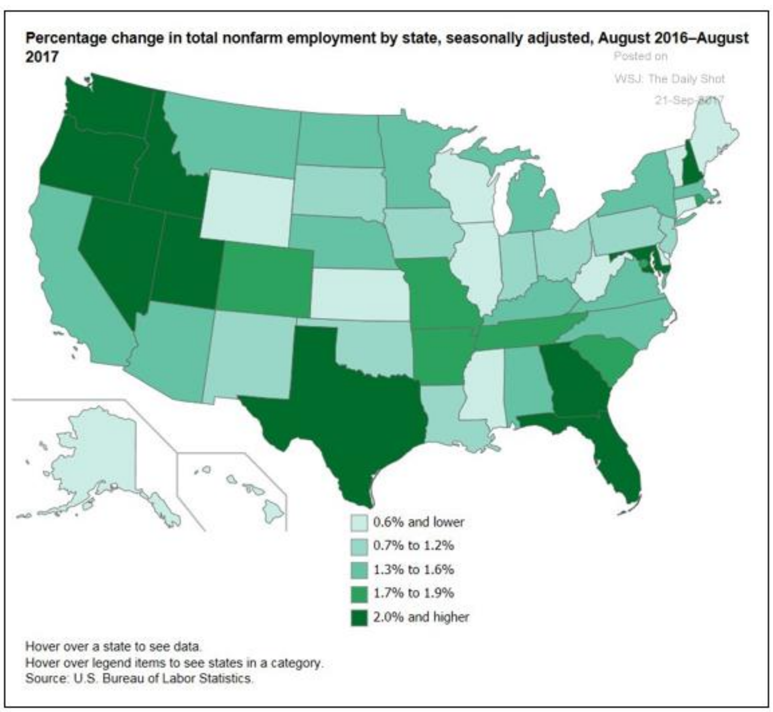
The August nonfarm payroll figures came in lighter than expected. Most likely, these figures will get worse once the impact of Hurricane's Harvey and Irma are factored in. Both of these events will definitely be a drag on overall GDP as well as employment.





In the process, the official unemployment rate inched back up to 4.4%. More importantly, annual wage growth has been tepid at 2.5%. This is making it rather difficult for the average family to make a meaningful increase relative to cost of living.

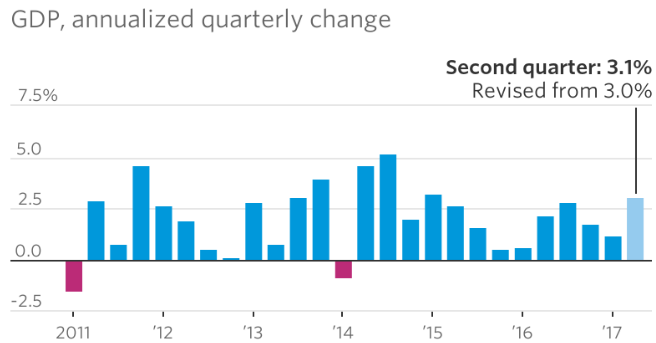
Overall though, the jobs picture remains pretty healthy as those filing for first-time unemployment benefits jumped to 298,000. It is estimated that more than 50,000 of these came as a result of Hurricane Harvey. Rough math would also estimate another 50,000 increase to come in the next reporting period from Hurricane Irma.



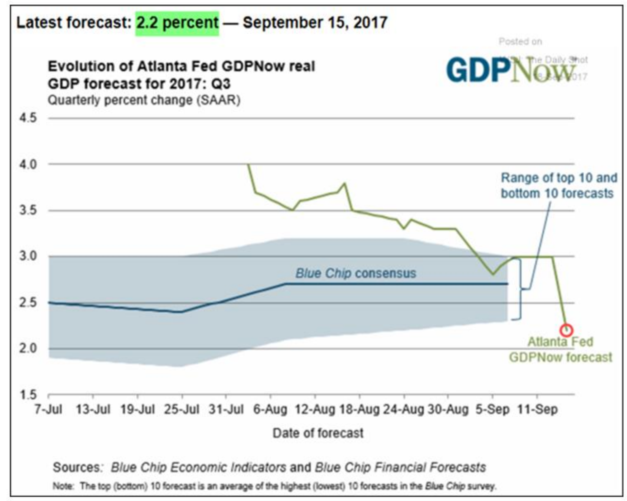
Prior to the hurricane impact, revised second quarter GDP rebounded to 3.1% level—a nice improvement from the slow 1.2% figure from the first quarter.

It is estimated that Hurricane Harvey will trim at least one to two tenths of a percent from the next quarters GDP measurement.

After factoring in Hurricane Irma, we can see nearly a full point reduction in GDP for the quarter.



Note: Adjusted for inflation and seasonality
Source: Commerce Department



Source: Atlanta Fed

The improvement in GDP, along with a rising stock market, has led to positive consumer sentiment.

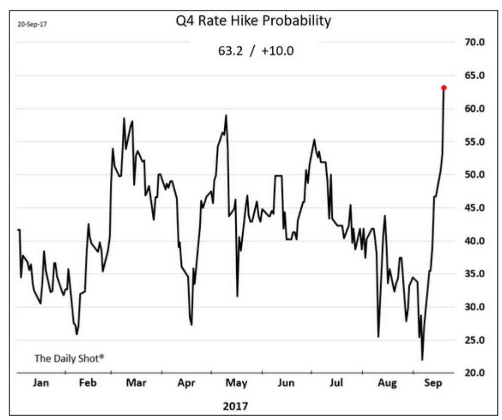
Both the Conference Board's Consumer Confidence survey as well as the University of Michigan Consumer Sentiment survey reflect generally positive attitudes that are above the long-term trend and improving.

Although there was a pullback in the non-manufacturing ISM report, it is worth pointing out that both non-manufacturing as well as manufacturing indexes are both above historical trends. Given the impact of the hurricanes, this should not be surprising…but is reassuring that our manufacturing base remains resilient.

After peaking at 2.6%, the 10-Year U.S. Treasury Bond has come back down to 2.3%--after falling as low as 2.02% in early September. Furthermore, since January of 2016, you can see that the spread between the 1-Year US Treasury and the 10-Year Treasury has narrowed from 1.7 percentage points to 1 point.

This is an interesting dynamic. The Federal Reserve has increased short-term rates—while the market has said that the economy is not strong enough to warrant higher long-term rates.
As such, the yield curve has continued to flatten and many now expect that Federal Reserve rate hikes will be limited to one more…or possibly, none-at-all.

There is currently a 63% probability for a rate hike this year. We discount the reliability of this metric. Two weeks earlier, there was only a 25% chance of a fourth quarter rate hike. We'll see.



Coincidentally, at the same time that open market interest rates have fallen, the U.S. Dollar has also declined. Many "experts" have pointed out the pronounced decline in the Dollar relative to other world currencies.

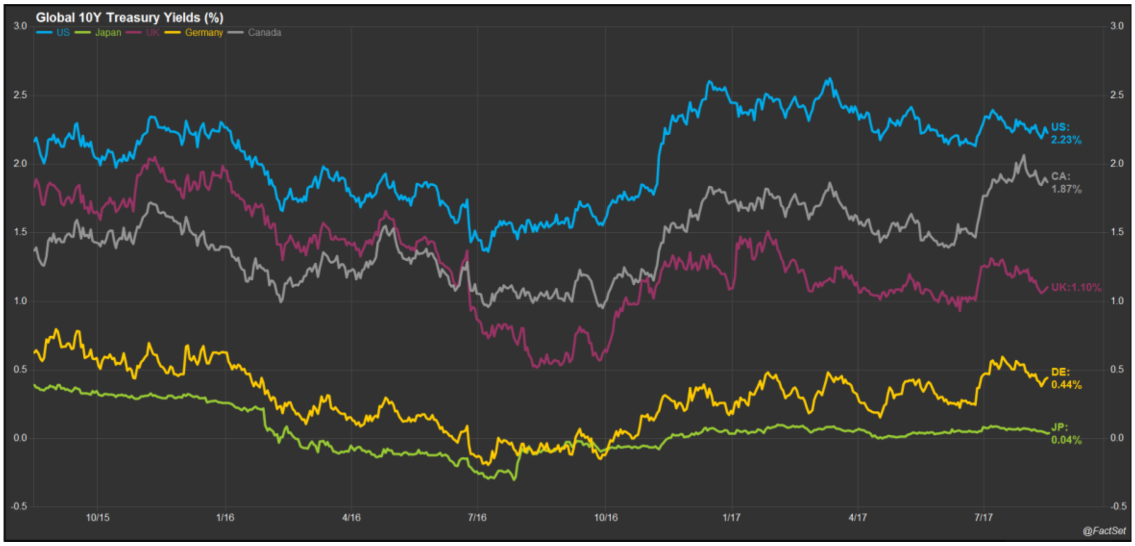
This is certainly not the end of the world. If anything, we think the decline in the Dollar is mainly a reversal of the large run-up after the U.S. Presidential election. Furthermore, a weakening of the Dollar has multiple facets to it.

A weaker dollar encourages foreign investment into the U.S. and makes U.S. manufacturing cheaper to sell to the rest of the world.

The best way we know of to insulate against a devaluing Dollar is to own assets that produce earnings—preferably in currencies from around the world.

Despite the slim returns of the 10 Year U.S. Treasury, it could be worse. The yield on the 10-Year Note continues to be significantly higher than Canada, the United Kingdom, Germany or Japan. And from the looks of things, none of the Central Banks are in a hurry to raise rates. Rather, everyone is trying to devalue their currency and keep rates as low as possible.

As such, fixed income investors should prepare for prolonged low rates and try to figure out how to position their portfolio to maneuver around a devaluing currency. Investing in multi-national corporations seems to offer the best long-term odds of success.

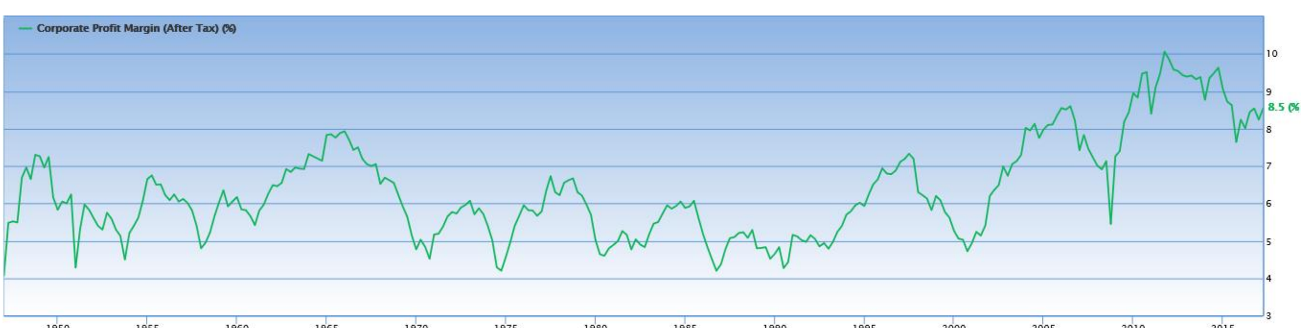


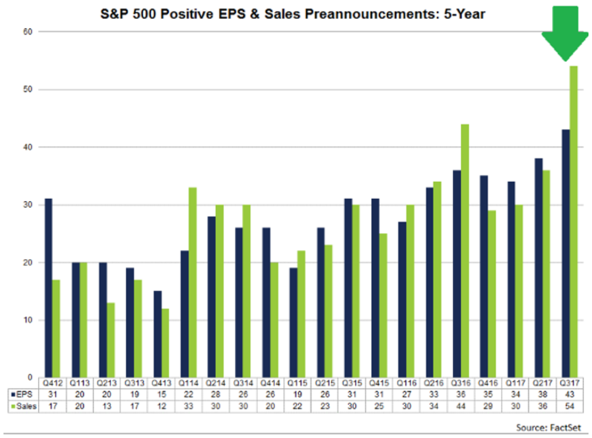
Lastly, although we favor stock market assets as the best place to produce long-term wealth—it is not a simple decision. Rather, it is the best of many difficult decisions.

The U.S. stock market is on the higher end of valuation. There are two things that allow us to "hold our noses" and continue to allocate funds in stocks.

The first is that earnings are improving making stocks less expensive. The current 10 Year Price to Earnings Ratio of 22.1 is clearly high.

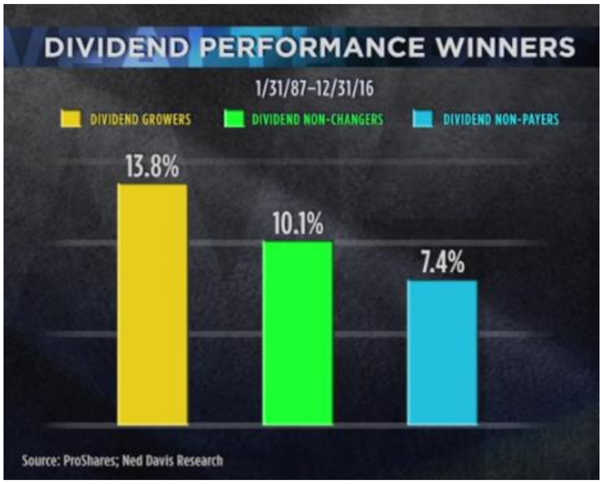
However, after a noticeable decline in net profit margins in 2015 and 2016, corporations are running more efficiently. As such,net profit margins have improved well above their long-term average. As profit margins have increased, the Price to Earnings Ratio going forward is 17.8. Again, not a bargain, but slowly growing into its valuation.

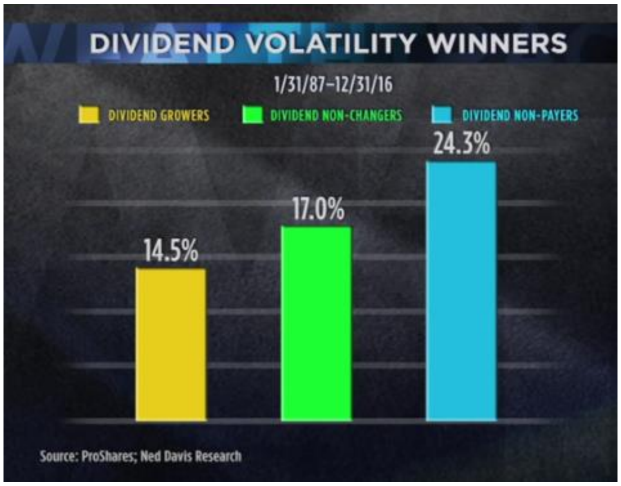


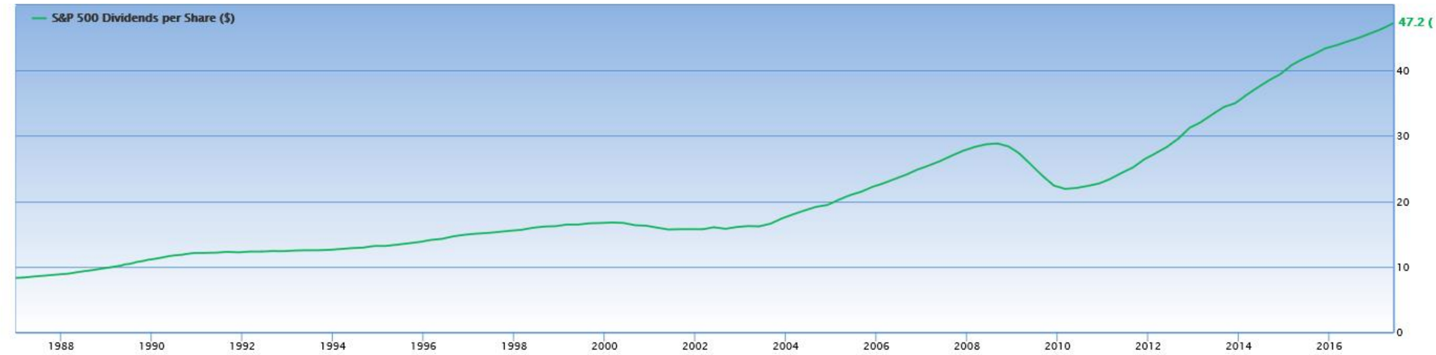


Secondly, in a world of ~2% long-term interest rates, stocks may actually be "fairly" valued. This does not mean that our attitudes about when to own stocks has changed. Owning a business is a volatile proposition over short time frames. We will only recommend owning stocks if we have a 10-year or longer horizon.

We continue to prefer tried-and-true boring "blue-chip" companies—ones with strong and growing dividends. Not only does this deliver good opportunities for long-term growth, but they do so with lower volatility and better cash flow than fixed income assets.







Lastly, we generally have the luxury of owning individual businesses instead of jumping into a "one-size-fits-all" portfolio that is really a black box. By owning individual companies, we believe we can continue to deliver above average income as well as a stream of consistently increasing cash flow.

Let us know what questions or comments you may have. This is a really boring business without our clients!

Sincerely yours,

Dave *Warren*

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