Market Update

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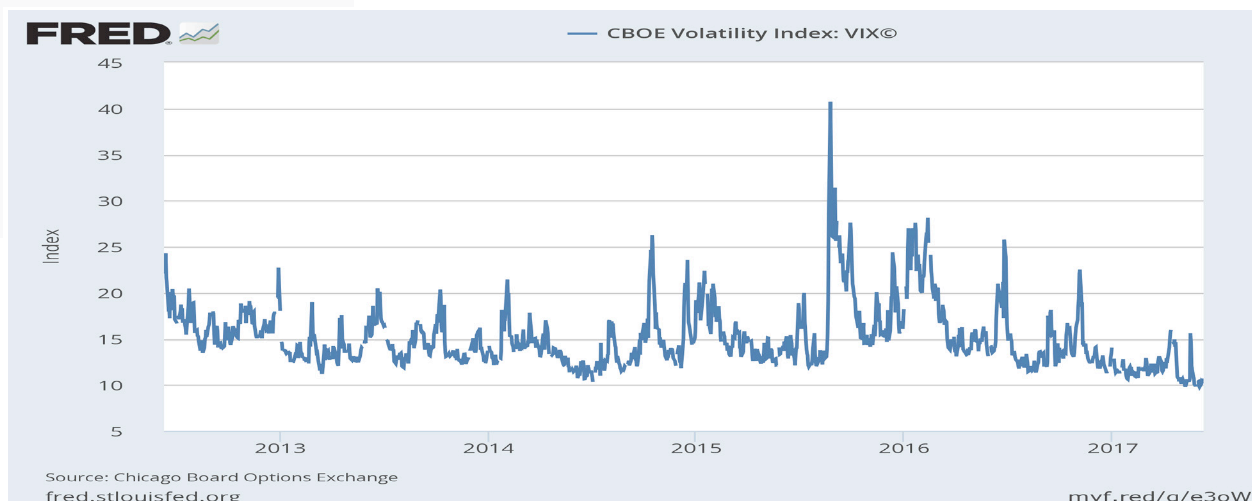
Markets, Volatility, and The Wall of Worry

As we have noted in the past, markets climb a "wall of worry", with a return premium paid to investors that is above and beyond risk free Treasury notes and dependent on how big and how many blocks are in the wall. Bull markets often end when investors no longer have any worries, and the equity risk premium is absorbed and baked into equity prices. Only 18 months ago, our wall of worry consisted of the Ukraine conflict, fragile European economies, and a Greek exit from the Eurozone; not to mention very low oil prices and the start of an earnings recession here in the U.S. Gleaning any possible market disruption today is much harder, and that should concern investors. To be sure, North Korea, an uncertain Federal Reserve path, and dashed expectations for the President's initiatives do present risk. But by all accounts, the VIX index—shown below—is reflecting a very tranquil, worry free market.

And for the first time, with no strike prices under the 10 level, futures traders are minting new strike prices for VIX futures-see the VIX prices on right side of the graph below. In stride, the markets continue to shrug off events that normally would be a catalyst for volatility—Comey hearings; UK election results; shift in ECB sentiment.



U.S. stocks remain somewhat overvalued but not in nosebleed territory, with the forward looking price/earnings ratio at 18x versus a 15x historical average. Even with the Fed looking to increase interest rates in June, rates continue to remain low and inflation remains relatively subdued. Yes, there are signs of wage inflation, but overall tepid growth should keep prices in check for some time. European equities remain the better value, with year over year earnings expected to rise over 20% in the European Union amidst a Central Bank environment that will continue to maintain low interest rates at least thru 2018.

Recent euro-area GDP data now confirm that gross domestic product is rising greater than initially estimated, and Mario Draghi has confirmed today that interest rates will remain very low for the foreseeable future. The result is a shift in global capital that now recognizes the relative growth story of the Eurozone vs. the U.S economy, with institutional and retail funds now flowing into international equities. Banco Santander recently acquired Banco Popular for one single euro, bolstering the story of a healing euro-economy. Of course the true cost of this acquisition will bear out in the over/underestimate of the loan write-offs that will occur over the next year.

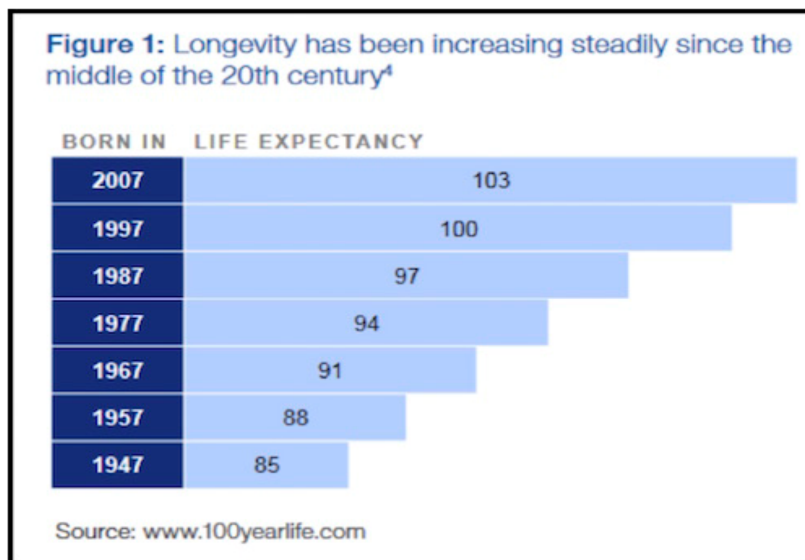
Growth stocks continue to outperform value stocks by a very wide margin, with the YTD return on the Russell 1000 Growth Index at 15.63% vs only 3.77% for the Russell 1000 Value Index. Like 2015, 2017 is another year of returns skewed towards a few large cap growth stocks, with only a few stocks making up approximately 30% of the 9.7% return in the S&P 500 Index so far this year. This represents a very narrow market and will require patience from value investors who enjoyed very strong returns in 2016.

So for now we see nothing on the horizon that would indicate a recession, and with global growth now back on the upswing, it appears this expansion could last at least through 2018. Global equities continue to offer more attractive valuations and better expected returns.

Centenarians - Changing the Planning Horizon

In a recent piece on planning for age 100, economist John Mauldin noted that most planning estimates are based on average life expectancy. For U.S. males, the number is 79.6. But that is the average. Mauldin notes a World Economic Forum paper that looked at the median life expectancy by birth year—shown below—for the developed world. Quite a difference versus the averages. So for example, those born in 2007 would have a median life expectancy of 103 years! The chart below is based on the "median" life expectancy, which basically means that half the people have shorter expectancy and half longer than the median numbers shown below. It is quite remarkable that the majority of today's young children will live well into the 2100's, and many can expect to see their lives span three different centuries!

Good news? Perhaps, but on many levels this presents the problem of how to plan financially for this longevity, and for us at FMA, how to manage our client assets to go the distance.



Slow and Steady Wins This Race - Dividend Income, Conservative Estimates, and Don't Forget Inflation

Dividend Income-Minimizing volatility is paramount to extending the duration of portfolio cash flow during retirement. Today volatility remains at all time lows, but equity investors must plan for the inevitable periods of heightened volatility which are likely right around the corner.

With this in mind, the income component of your portfolio will be more important than ever in achieving this cash flow while limiting portfolio volatility. Over the long haul, this strategy should provide a more consistent return stream that holds up during periods of market stress. And like any strategy, it requires patience and discipline for income oriented value investors who year to date are underperforming growth indices by a wide margin.

Erosion of Purchasing Power-Retirees experience a higher degree of inflation than the number used to adjust social security benefits. Compounding is a wonderful thing for asset growth, but it unfortunately has the same effect on your expenses over time, and even more so in the later years of the plan. Your portfolio will need a greater growth component to offset the effects of inflation over time.

Conservative Estimates-Finally, it is important to be realistic with return numbers. The reality is that equity returns come from three simple things—dividend income, expansion of the price/earnings ratio, and the pass through of earnings in the form of dividend growth . Right now, in the U.S. we are at a relatively high starting point in price and low point in yields, so return estimates should be tempered with reality, and global diversification increased with the objective of finding a lower starting point, price and higher dividend yield.

While we hope that the summer months remain calm, a market correction is overdue and would not be a bad thing amidst an environment of solid earnings and expanding global growth. We welcome an opportunity to review your portfolio and work with you on developing a life plan to meet your financial goals. Please call us to schedule an appointment.

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