American Heritage Financial

June Update **June 1, 2017**

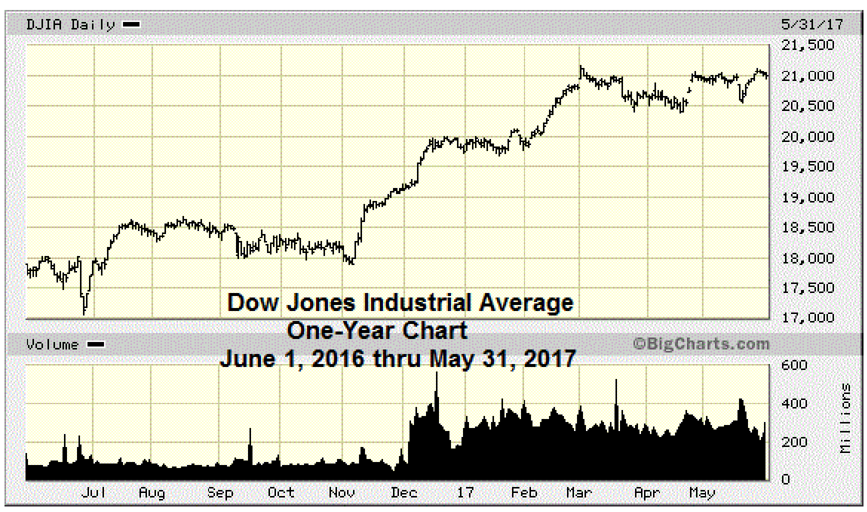
The Wall of Worry

Or, Why does the market continue to go up if the outlook is so negative?

It is easy to find many valid reasons to be concerned about the stock market in June 2017.

- This is now the ***second longest Bull Market*** in history; in its ninth year.
- The S&P 500 is ***up nearly 260%*** since the 2009 low, an annual average return over 16%.
- Stocks ***valuations are "high"*** based on historical criteria.
- The Fed is – reluctantly – in the process of ***raising interest rates***.
- The ***"Trump Trade" is fading*** as fast as a reality TV show.
- Debt, pension and entitlement ***obligations continue to mushroom*** around the globe.
- Social and political ***conflicts are more extreme*** and exacting an increasing toll on economies.
- U.S. growth is still strong but dollar weakness and treasury spreads signal ***slowing ahead***.

Following is our explanation of why these major issues are currently worrying investors (at least some of them).



The bull market celebrated its eighth anniversary in March. It is now the second longest ever and the S&P 500 has averaged an annual gain of better than 16%—scary thoughts to those who understand that trees don't grow to the sky. On the other hand, the age or return of a market is not a reason that it can't continue. Stocks prices (in the long run) reflect overall economic health and there is no reason, under the right conditions, that an economy can't be "healthy" indefinitely. However, there is that pesky little phenomenon called ***"cycles"*** which govern most of our world and economic and stock market cycles are nearly as dependable as laws of physics. Timing of these cycles varies but no one can deny that the current positive cycles are "long-in-the tooth" and will reverse—***eventually***.

The favorite measure of valuing stocks is price to earnings ratio (P/E); or the price of a stock divided by its earnings. This reflects the cost of for each dollar of earnings. Investors consider the P/E for the most recent twelve months of ***reported*** earnings (since that is factual) and they are even more concerned with ***future earnings***, which are often hard to predict. According the FACTSET, as of May 30, the S&P 500 is trading at 23.9 times trailing earnings and 17.6 times estimates for the next twelve months. The 17.6 forward P/E is clearly expensive relative to the five year average of 15.2, according to FACTSET. Some justification for a higher than average P/E is strong growth estimates over the rest of the year as well as extremely low interest rates (making alternative investments less attractive relative to stocks). The P/E valuation metric tells us that ***earnings must continue strong growth to justify future stock market gains***.

The Federal Reserve's purpose is to promote a strong U.S. economy and its top two specific goals are to *maximize sustainable employment* and *stabilize prices*. In the depths of the financial crisis, the Fed took extraordinary measures to stimulate the economy such as ultra-low interest rates and injecting cash into the system. Now, nearly nine years later, the Fed has done precious little to reverse those extraordinary measures. Monetary stimulation is similar to a drug to relieve pain; it may be great for a while but eventually it becomes less effective and ever harder to discontinue. Also, like a drug, stimulation has unintended negative consequences. The most obvious, touched upon above, is that equity assets become valued more highly than debt relative to when interest rates are "normal." With current strong employment, low (too low) inflation and on-and-off again economic strength, the Fed is walking a super delicate tight-rope with the need to raise rates without slamming on the economic brakes. An old and famous market adage is ***"don't fight the Fed'"*** and the Fed is sure to raise rates and reduce stimulation through 2017.

The election of Donald Trump was a turning point for our country in many respects. Initially, the economic message was clear and the business community was euphoric about prospects for less regulation, lower taxes and infrastructure spending. Business confidence went through the roof and business activity and stock prices reflected that optimism. Stocks of financial firms, energy, materials and construction companies moved higher in anticipation of an improved business environment. The Trump effect was evident in the 12% surge in stocks from November 8 to Mach 1 (after nearly two years of flat market returns) and it was most pronounced in industries expected to benefit most from the proposed pro-business agenda. Now, four plus months in, it is increasingly evident the entire pro-business agenda is on life support. Much of the euphoric price gains in financial, construction and other industries expected to benefit from the promised changes, have evaporated. Still, the ***overall market, like the economy, remains healthy*** and the March 1 highs were eclipsed in late May. Stocks can perform even if the chaos and dysfunction in Washington worsens but the ***tailwind of Trump promises is beginning to feel more like a headwind***.

The U.S. and most all other global economies have long been under ever increasing stress due to excessive debt, slow economic growth, social unrest and political instability. It seems that most financial markets have become fairly inured to these general concerns in spite of the possibility that any one of them could have dramatic economic consequences. With the exception of a recent invigorating up-tick in a number of long suffering foreign economies, all of these issues are one more dark cloud hanging over our financial markets.

So, with all of this negativity, **why is the stock market hitting new all-time highs as recently as the last full week of May?** It is because, as important as each issue discussed might be in the long term, they are all terrible timing indicators for the stock market. Markets are driven by many factors but positive investor sentiment, once it gains momentum, can overwhelm all other considerations. Current positive investor sentiment is driven by strong recent returns, by a lack of attractive alternatives, by excess liquidity and by (still) optimistic expectations for economic growth.

All this said, our approach has never been to "buy markets." Rather our investment strategy is based on buying *high quality, productive investments (usually stocks) which will produce growth and profits to generate positive returns*. We attempt to buy such investments at bargain prices; selling can be more ambiguous. ***We do not believe in market timing***—although we occasionally attempt minor "adjustments" to reflect market conditions. As an example, we recently increased exposure to foreign markets due to their relative improvement in valuations and outlook versus the U.S. market. As we continue to monitor the many issues affecting the value of your portfolio, please don't hesitate to contact your advisor to get an update on our current thinking.

Best regards,

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Questions or comments?
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