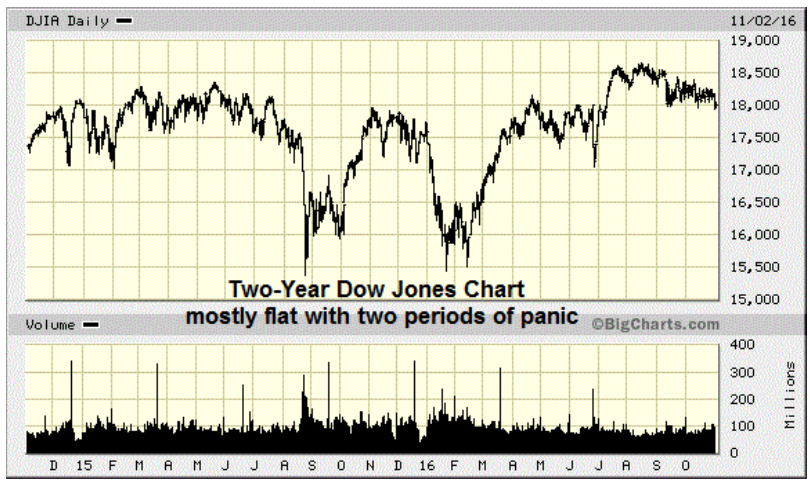
American Heritage Financial

November Update **November 2, 2016**

A Tale of Two Years

While the past two years pale in comparison to the revolution and terror portrayed in the Dickens classic, ***it has been a scary and unprecedented time for financial markets.*** It was two years ago when oil prices first began the 18 month decline which put the entire energy industry on life support and threatened a Lehman-like contagion of the financial system and economy. China's enigmatic economy has also been an increasing risk during this time. Clear signs of a slowdown in the Middle Kingdom was a major reason for the global collapse in commodity prices and weakened neighboring emerging economies. The long fragile European economy suffered from escalating terrorism and immigration woes over the past two years, and—now—Brexit. Of course, we can't forget anxiety over our own eminent election—an event for which the words revolution and terror certainly apply, depending on one's views.

The financial impact of all this tumult and worry is that interest rates continued lower, even into negative territory, while the market's *"most dependable"* stocks—such as utilities, consumer staples and big blue chips—were rewarded for their stable businesses and hefty dividends.



We are not at a level of revolution or terror (hopefully), but the market is still frightened. A key point, however, is that the reasons for concern are beginning to change. Hints of solid economic strength in the 2.9% jump in the third quarter GDP report, along with a smidge of inflation reflected in September's 1.5% increase in CPI (consumer prices), make a Federal Reserve interest-rate hike likely by as early as December. The bond market has already reflected stronger economic conditions in the increase of the ten-year U.S. Treasury rate; which moved from 1.55% at the end of September to 1.85% on October 27. The specter of a revived economy, a bit of inflation and higher interest rates has investors *reconsidering some of high prices they paid for safety and yield.* As investors look around for places to move their cash, some of the markets most neglected sectors—those with the most obvious problems—might just be the place to go.

For much of the past two years, beginning with oil's peak in July 2014, default risk was the driving force of what worked—driving investors to stable-business low-volatility stocks and strong dividend payers. Collapsing oil prices created fear of mass bankruptcies—not just among energy companies but also industrials, banks, and other companies exposed to those businesses. Since oil's rebound in April, default risk has decreased and it appears risk will continue to ease, similar to the decline in default risk after the Lehman Brothers' bankruptcy in 2008, and the Greek debt crisis in 2010.

That has made the market safer for risk-taking, but hasn't alleviated all fears. Fear is shifting to a more fundamental focus on valuations—both high and low. We continue to see anxiety represented by low valuations in industries such as energy companies, airlines and automakers—industries which have always sported low valuations due to their cyclical natures. Investor concerns are also reflected in low valuations in retailing as that sector undergoes a titanic shift in the face on online competition. Financial companies that specialize in money management are also depressed as these companies face new competition from robo advice and exchange trades funds. These, and other industries, face challenges with no easy solutions.

The opportunity for investors is recognizing the fears and balancing them with reality. Retail stocks are a good example; the group is down over 2% so far in 2016 (and some stocks have been crushed) as it struggles with changing consumer shopping habits. It appears, however, that the group's woes are now reflected in their valuations. Retail, as a group, is trading at multiples similar to those at the worst of the financial crisis while earnings revisions have started to stabilize and even improve. Some analysts point to retailers as one of the cheapest sectors of the market, along with select opportunities in the other "cheap" sectors mentioned above.

Still, it isn't time to go "all-in" on economic growth, higher interest rates, higher commodity prices and the long neglected "cheap" sectors of the market. Recent economic improvement is a welcome sign and some adjustments to portfolios may be appropriate but imbedded debt, structural, demographic and political issues will continue to thwart explosive growth—*keeping risk aversion an important ingredient in investment strategy*. High quality investments—hopefully at reasonable valuations—continue to be the mainstay of portfolios. We hope to navigate this changing environment in ways to capture some of the cyclical upside while defending against the ever present risks of the financial markets.

Best regards,

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Questions or comments?
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