

Third Quarter Market Outlook 2017

What Comes Next?

As we look back on the first half of the year, we review what has generally been a up trending stock market, and a mostly flat bond market. The stock market is reflecting a better economic outlook and better than expected earnings in the last quarter. The political climate has become quite contentious, however, and agreements in Washington pertaining to budgets, taxes, environmental policies, and a sharp reduction in new regulations, have all had the effect of splitting Congress into two factions. In this commentary, we will talk about the current infighting in Washington, as well as, the change in the direction of the Federal Reserve Bank policy and what it means for stock and bond prices.

Even with a majority in both the House and Senate, the Republicans have been unable to pass the items that businesses want most- namely lower corporate taxes and roll back of previous regulations. The infighting in Washington is beginning to have a slowing effect on the rise in equity prices over the last few months. If the year continues without any meaningful business legislation, we believe the equity markets will begin to stall.

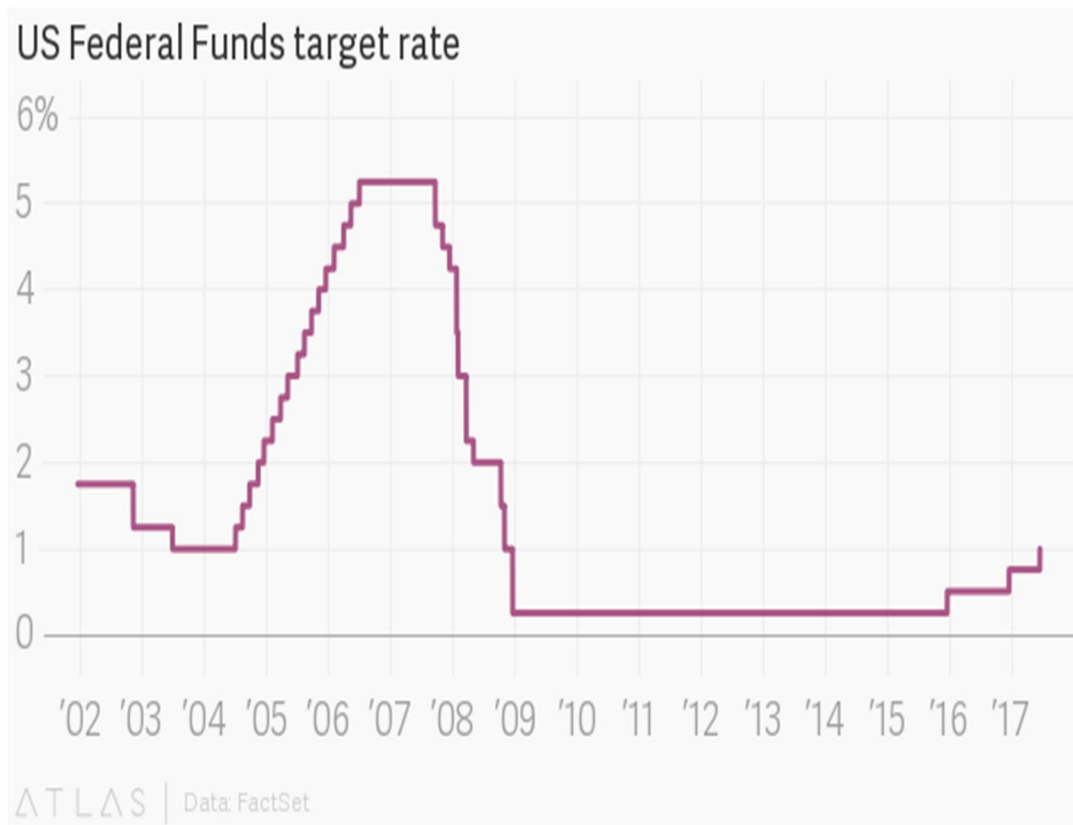
U.S. taxes on corporate income are among the highest in the world at 35%; only Puerto Rico and Qatar have higher rates. While we don't believe there is even a chance to reduce rates to 15% (which was Trump's original proposal), we believe both political parties and both Houses of Congress may well join to reduce corporate rates to a lower level, quite possibly 25%. (The OECD- Organization of Economic Co-operations and Development members report an average tax rate of 22.5%). The tax rate now has created unintended consequences. Many U.S. based corporations keep their profits overseas to avoid the tax, but they still have to report the tax on

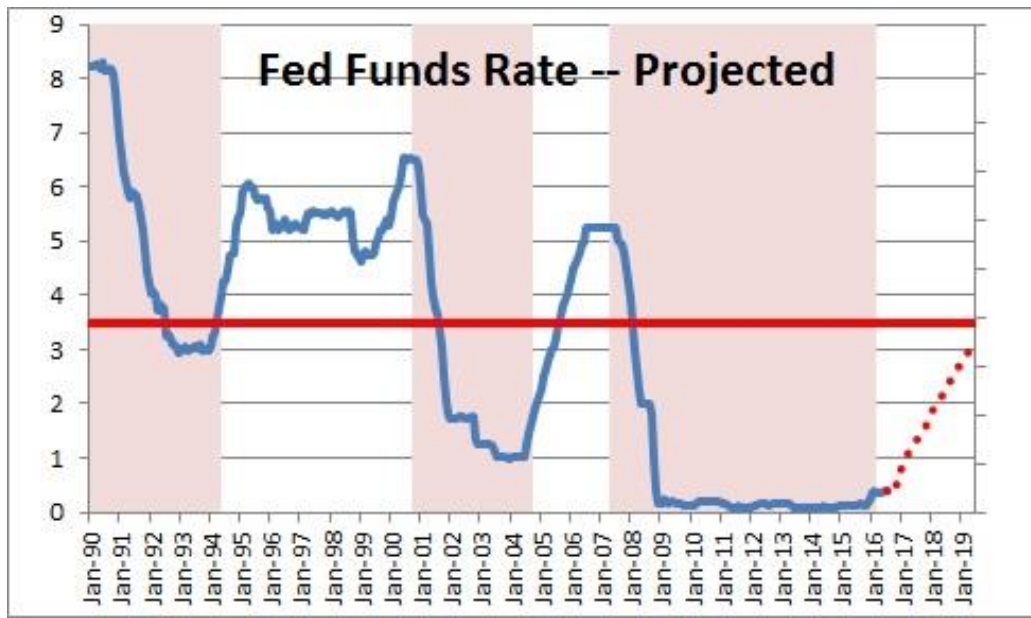
earnings reports to investors (thereby depressing earnings), the U.S. Treasury does not receive the tax revenue, and the corporations cannot use the cash to reinvest in their American operations. If we do get tax reform, we believe the stock market will head higher, particularly if the lower rate will be applied to individual taxpayers as well.

Meanwhile, while everyone seems to be looking at the stock market, we believe the real story may be underway in the bond markets in general, and with the Federal Reserve holdings of bonds in particular.

Federal Reserve Bank Changing Policy

On June 14th of this year the Federal Reserve initiated its fourth consecutive increase in interest rates, beginning in December 2015 with ¼ of 1% and again in Dec 2016, and in March and June of this year. The current rate hike brings the Federal Funds Rate to 1¼%.





While these rates are still far below interest rates of previous years, it sets a signal that the Federal Reserve is beginning to tighten money, albeit at a very slow pace.

Historically this is bad for stocks, in that rising rates mean higher yields for bonds, and other interest bearing securities. Higher yields on bonds, which are considered safer than stocks, makes stocks less attractive.

In turn, the Federal Reserve is also taking beginning steps to “normalize” interest rates. Recall that interest rates have hovered near zero for practically eight years, reflecting deflationary concerns and sub-par economic growth. During this past period of time, the Fed not only kept interest rates low, it also used its ability to create monetary reserves to buy government obligations and debt instruments from the banking system to provide liquidity to banks. The net effect of this process was to increase the assets on its balance sheet, such that the Fed now has over \$4.5 trillion dollars of assets on its balance sheet. This amount, over some period of time, needs to be reduced. The process by which reduction occurs is called Normalization, and consists

primarily of selling off parts of its portfolio, and/or not reinvesting funds when issues on their balance sheet mature.

Remember that the Fed stopped its printing of money and buying bonds in 2014, but it has refrained from shrinking its balance sheet until now. At \$4.5 trillion, the Fed's balance sheet is equivalent to about a quarter of America's annual gross domestic product; so this is a big deal. At the time, it was very controversial when the Fed began an unconventional printing of money and then used those dollars to purchase bonds which in turn broke the deflationary spiral of the financial crisis. This program was known as quantitative easing, and we commented on it several times during that period.

The printing of money, which primarily occurred during the 2008-2012 time period, forced interest rates so low that Americans started to buy houses again as well as other products, and it led many income investors into investing in stocks, rather than bonds, because bond yields became too low to be attractive. In fact, interest rates reached the unusual scenario where dividends on stocks paid more than bonds during the financial crisis. This created a giant support level for securities, and helped the market climb out of steep declines during the financial crisis. So, the risk now is that the Federal Reserve moves too fast, and sends us into a recession by causing interest rates to increase, too quickly. High interest rates are a direct impediment to home and auto sales, two pillars of the economy.

Since printing of money in and of itself is inflationary, the Federal Reserve now believes the economy is strong enough to reverse its printing of money and has indicated it will start taking dollars out of the American economy to prevent long term inflation within the next few months. In essence, it is trying to go back to a normal situation.

How the Federal Reserve Used its Balance Sheet to Support the Market

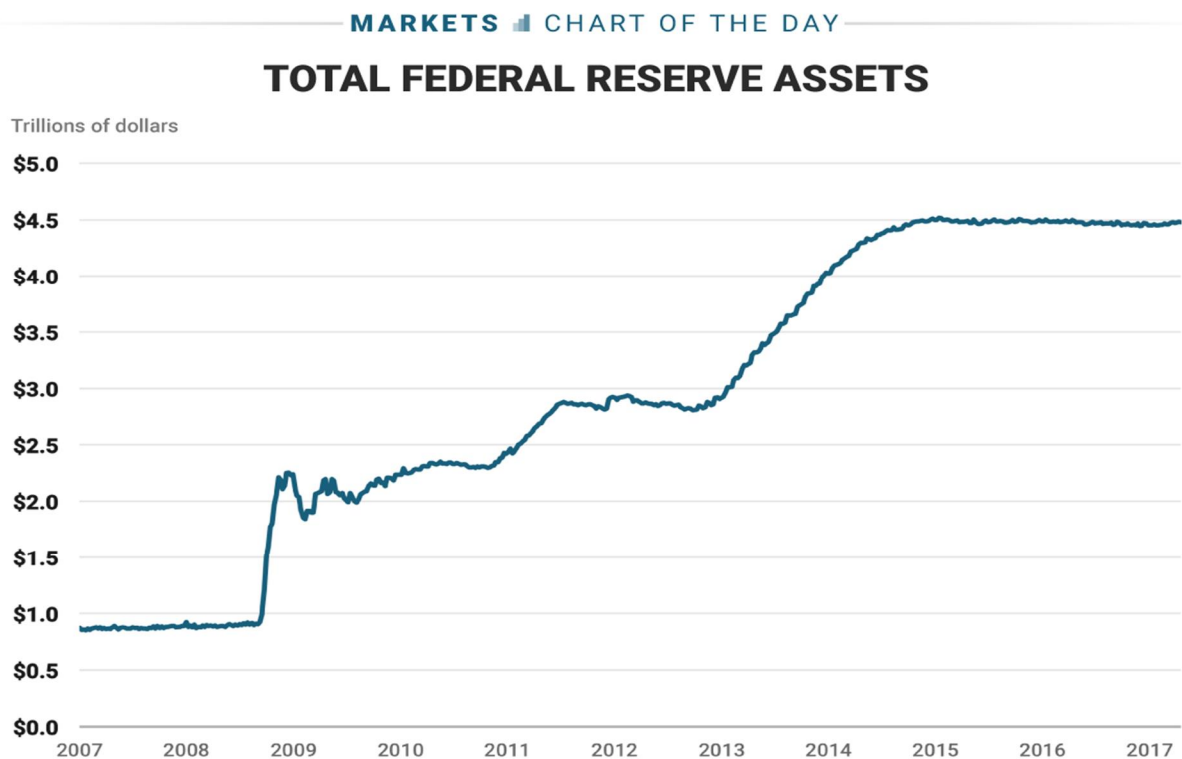
During the Financial crisis, the Federal Reserve used its ability to print money, and used that money to buy securities. The original holders of those securities sold their securities in open markets and received cash from their investments via the Federal Reserve. The Federal Reserve received the investor's securities, which were usually mortgages or treasury bonds, and held on to them. The investors who sold their securities for cash, now had cash with which to buy other securities. Since most institutional investors have to be 95% invested by their bylaws, the Federal Reserve bought assets from institutional investors. These institutional investors would then take their cash proceeds, and turn around and buy other securities. Thus, the Federal Reserve was able to re-liquify market participants, and the investors purchasing of new assets caused both stocks and bonds to move higher as new money entered into the financial system.

Fast forward toward to today, and the Federal Reserve is now letting the bonds it purchased during the financial crisis expire. So, as a bond borrower pays back the loan, which the Federal Reserve Bank now owns, the Federal Reserve is now keeping the repayment and deleting the currency. In effect, it is undoing what it did in the past. The risk here is that if the Federal Reserve lets too many of its bonds expire too fast, it could cause a liquidity crunch and inadvertently start a new recession.

Many of our readers may ask why we did not see more inflation during the financial crisis due to the massive printing of the money during that crisis. The answer is twofold. First, we did see a lot of asset inflation, but it was concentrated in stocks and real estate. This inflation in stocks and real estate also widened the wealth gap over the last several years because citizens who owned assets have done ok, while those who do not have fallen further behind. (This is one driver for the income equality argument so prevalent in political circles.) To go further,

however, the reason we did not see more product inflation during that period was that our trading partners did not want to lose their market share in the lucrative American market, so they printed (devalued) their own currencies so that they would not give up market share in the USA.

Remember that when a country prints money, its currency becomes cheaper (worth less value), so products produced in its currency become cheaper as well. Thus, other countries tried to negate the U.S. trade advantage by lowering their own currencies. Thus, the buying power of the U.S. currency remained fairly strong, although our manufacturers did not get much relief from foreign competition.



SOURCE: Federal Reserve Board via FRED

BUSINESS INSIDER

The goal of the Federal Reserve Bank is to shrink its balance sheet into a strong economy, and strong market so that the Fed's own selling pressure does not hurt asset prices. With the strong market rally after the election, and increased consumer confidence, the time seemed right to act for the Federal Reserve. Indeed, Consumer confidence numbers are the

highest they have been since the early 2000s, and tax cuts and lower regulation should boost growth.

However, signs that the economy may not be as strong as investors would like are already starting to appear. March vehicle sales are down 10% from December 2016, and weaker than expected GDP growth numbers have been reported. Auto loan delinquencies are also rising. New housing starts fell to an eight month low in May, and the Restaurant Industry Association, which tracks 27,000 restaurants, reported same store sales down 1.1% in May. So the question becomes, if the economy is so strong, why are we not growing faster, and why are we seeing signs of weakness? Is the stock market placing too much hope on a corporate tax cut that may not come? Moreover, valuations are expensive and priced for good news. At nearly 18 times expected earnings for the coming four quarters, stocks are trading above the average 16 times forward earnings according to Factset Research. Thus, a major risk to the market is that the Federal Reserve starts its selling program before a stronger recovery takes hold. We will be watching this situation carefully.

In conclusion, we think the market has moved ahead of its near term fundamentals and is pricing in positive developments that have not yet, and may not happen. Although we think corporate tax cuts would help valuations in the market we believe that a lot of that speculation has already been priced into valuations. We also think that not enough attention has been paid to the Federal Reserve's intentions with its balance sheet and that it will become more important in the second half of the year as they begin to start their selling process. We also hope for stronger GDP growth this year (and think lower corporate taxes will help), but it is unfortunate that recent economic reports do not support that conclusion as of yet.

Long term we are still bullish on equities as a way to capitalize on growth and new technologies. We also think interest rates will stay below historical levels due to the massive

Federal debt levels in the United States, which becomes increasingly difficult to service with high interest rates. Thus, we believe the long term outlook for equities is still favorable, and we are still focusing on companies that can grow regardless of the economic cycle and whom are returning cash to shareholders either through dividends or stock buy backs. As always, we thank you for your support.

Sincerely,



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