

Oct 11, 2018

Key Points

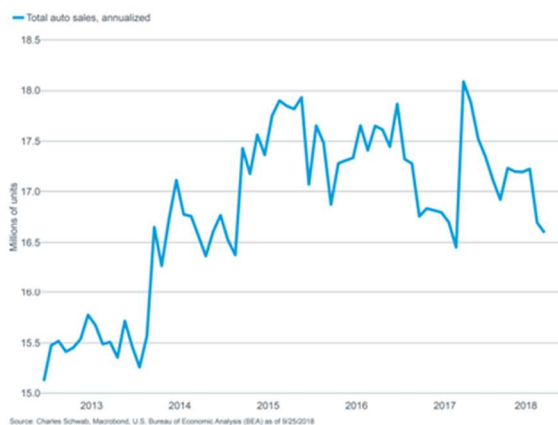
- U.S. stock indexes again hit record highs but sentiment and action below the surface may indicate a less bullish picture. The uptrend should continue, but risks have risen, and we believe the signal is for investors to have a neutral stance.
- The economy looks strong, but are housing and autos sending a different signal? The Federal Reserve again boosted rates, and looks set to continue, but are they moving from accommodation to tightening?
- Higher oil prices have the potential to impact central bank actions.

Mixed messages - U.S. economy looks strong, but are there cracks below the surface?

It's easy to look at equity indexes in the United States hitting record highs and believe that all signs point to further bullish action. However, below the surface there are some developments that we believe warrant a bit of caution. Investor sentiment is in the overly optimistic zone according to the Ned Davis Research Crowd Sentiment Poll, which can herald a near-term pullback.

With estimates for S&P 500 year-over-year earnings growth standing at about 21%, the bar is set quite high, and it could be difficult for the majority of companies to beat those elevated estimates. Upside surprises may be difficult to come by, potentially limiting market gains as we finish out the year. For now, earnings growth remains a support for stocks, and the healthy corporate picture is boosting the consumer via job growth and confidence. Initial jobless claims are at their lowest levels since the late-1960s and now "threatening" to move below the 200k mark, which is almost unheard of.

The strong labor market has boosted consumer confidence, which continues to hover near record highs. But here too we have a bit of a mixed message. Confidence is high but auto and home sales have been weaker.

**Rising yields haven't hurt stocks...yet**

Rising bond yields, however, could pose a problem for stocks in the not too distant future should the trend continue. Higher yields have made the valuation picture more difficult to justify, while they also have the potential to make fixed income securities more attractive; which could move even more money flow from equities to fixed income. Updated expectations are now that the Fed will hike rates once more this year, and three times next year. Finally, stocks largely shrugged off the announcement of additional tariffs between China and the United States—

perhaps relieved that they weren't as large as might have been expected. But the threat of further escalation remains very much in play.

Oiled up

The global benchmark for oil is Brent Crude and the price of a barrel is up 22% this year—bringing the price to \$82, the highest level since 2014. It's possible this may push up headline inflation readings and force global central banks to consider responding with higher rates than currently expected by the markets, which could bring about a premature end of the business cycle.

Midterm Elections

November's midterm elections are now just around the corner, and the potential for major political changes is high. Since 1934, the president's party has lost an average of 30 House seats and four Senate seats in the midterms. If those averages hold in 2018, control of both chambers of Congress will flip to the Democrats. However, in these highly partisan times, wresting control of Congress doesn't necessarily mean taking control of the policy agenda. Whichever party wins, the majority's margin of control will likely be slim and fall short of the supermajority of 60 votes needed to really control the agenda in today's Senate. Neither party anticipates being anywhere close to that after the election.

Another issue for investors to watch is the return of the debt ceiling. This cap on how much debt the federal government can accumulate will be suspended through March 1, 2019. When it returns, the new Congress will have a choice: Vote to raise the ceiling or otherwise address the debt, or the country will potentially default on its debts for the first time in history. In recent years, increasing the debt ceiling has been a huge political challenge—and markets have grown skittish when Congress has flirted with a potential default.

So what?

One of our favorite institutional managers released commentary that really hit home with us and we will reflect on some of it here as well. It is easy to get caught up in the euphoria and overlook the potential risks that are lurking. Credit analyst Doug Noland recently noted, "I've been here before and, candidly, it's not much fun." Most investors with a more conservative approach nod in agreement, as everything is obvious in hindsight. Most now acknowledge that in 1999 there was bubble in technology. Looking back at 2007 many now agree that there was a huge bubble in housing and credit. However, history shows that the majority of market participants at the time possessed deeply embedded bullish convictions during both bubbles, as any opposition to the bubble viewpoint was opposed. One wonders if that, some years into the future, the conditions prevalent today in 2018 will also be remembered as self-evident.

Yet risk-takers are being generously rewarded while more conservative investors are pushed aside. Trillions of dollars flow into passive investment strategies and away from investors who actively seek to manage risk, a perception of invincibility that rivals 1999 and 2007. What will be clear in hindsight is obscured in real time. Markets repeatedly reward complacency and risk taking. Why should it not continue? A view that differs from the consensus appears irrational. So long as confidence holds, and speculation remains unrelenting, risks remain concealed. Which is why German philosopher Arthur Schopenhauer's quote resonates so well today, "All truth passes through three stages: First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as self-evident."

The unique conditions of the last decade have fueled enthusiasm for the highest growth strategies, while value-oriented managers have severely lagged the broader indices. In timely fashion, Morningstar recently published a paper titled "How Long Can a Good Fund Underperform its Benchmark?" Morningstar examined mutual fund slumps by using existing fund histories from the United States, Canada, Europe, and developed Asian markets. The authors calculated gross returns over fifteen years (2003 through 2017).

Of the 5,500 equity funds that qualified for the study, two thirds had higher returns over that fifteen-year period than did their costless benchmarks. Some of the conclusions of the study are surprising. First, strategies that did in

fact outperform their benchmark actually trailed their benchmark for an average of nine to twelve years over the fifteen-year investment horizon. Further, just as the winners suffered through periods when they looked like losers, so too did the losers often **appear to be winners**. On average, funds that trailed the indexes for the full fifteen years had eleven and twelve-year stretches of outperformance. The study concludes that the conventional performance-measurement periods (3-year, 5-year and 10-year) are far too short to determine management skill and "Investors who believe they picked a good fund must show more patience than is commonly assumed."

As investors, we choose the investing path that most closely fits our philosophy, remaining price-sensitive and cognizant of risk. After all, risk is not inherent in an investment; it is **always** relative to the price paid. While today's popularity of passive investing drives the valuations of the indices and select growth stocks to record levels, we take comfort in the lessons of history that we are, yet again, avoiding another mania that will look obvious in hindsight.

Given the unique market conditions of the last decade, many portfolio managers have generated strong near-term results by violating their own philosophy and "evolving" their investment process. In contrast, every notable investor we respect has achieved their long-term success through a strong faith in the values and principles at the heart of their process. These seasoned and highly successful investors have long recognized what the Morningstar study recently proved: a value-oriented, consistently-applied process will likely underperform more often than outperform - **yet ultimately dominate over a complete market cycle**. In up markets, the most aggressive managers look the best. In down markets, the most conservative managers look the best. What we are looking for are the managers that look the best when you factor in full market cycles, ups and downs. That's where you want to be. Remaining true to one's philosophy and process is not only the right path, it's ultimately the most profitable path.

We like to quote Benjamin Graham, and why wouldn't we? He is, after all, Warren Buffett's mentor. He said "The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go." We couldn't have said it better. As friends and managers of our client's capital, we care about you and your loved ones. And we care about you and your loved ones being in a position to enjoy a "Life Well Lived". Because in the end, it's not the years in your life that count. It's the life in your years -- and we are fully committed to being a meaningful part of that.

Respectfully,



Anthony L. Christensen, CPWA®
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