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October 4, 2017

The third quarter of 2017 has extended the trend that began a year ago. Corporate earnings should increase again this quarter (companies begin reporting this month), continuing a trend that began during the fourth quarter of last year. In fact, it is possible that earnings for the last 12 months will exceed the previous high point set three years ago. It has been three years since we have seen earnings this high.

Even though earnings are expected to be close to the same level as three years ago, the market is about 28% higher. Clearly, market participants are more enthusiastic today about prospects than they were 3 years ago in October. I suppose you could argue that investors were correct then, since we were heading into an earnings recession at the time.

What is clear todayis that market valuations have continued to rise, and it is a fair question to wonder how long this trend can continue. Stocks follow earnings over time, and it is difficult to bet against stocks when earnings are in an uptrend. Stronger economic growth is the theme across the globe today, and this is expected to continue. At some point, however, the market will need to come to terms with its valuation. As I have stated before, valuation can be ‘fixed’ through the market falling, earnings rising, or some combination of both. With earnings rising, it is certainly possible for valuations to come down while the market remains close to current levels.

During the quarter, The S&P500 rose another 4%. This brings returns to about 12.5% for the year. Every sector except for Consumer Staples increased during the quarter. Consumer Staples fell 2%. International stocks continued to contribute to overall returns. Whereas the S&P500 returned 12.5% for the year so far, the Vanguard Total World Stock rose 17.7%. This fund follows the FTSE Global All Cap Index and has about 48% of its assets in international stocks. In our diversification, we typically have a smaller amount allocated to international, but the better performance does show how international stocks have improved performance so far this year.

Bonds have begun to show how they might behave in a rising interest rate environment. Year-to-date, the iShares Core U.S. Aggregate Bond ETF, which follows the Bloomberg Barclays US Aggregate Index, rose 3.1%. This positive return, however, just fell shy of making up the losses experienced during the fourth quarter of last year. The 12 month return for this fund was -0.03%. Over this time period, the 10 year Treasury yield rose from 1.55% to 2.3%. If interest rates continue to rise, minimal returns continue to be possible investing in intermediate term bonds.

Where do we go from here? I would argue that the market is at least 10% overvalued. One year from now, current expectations call for earnings to be 18% higher. This suggests that there is enough juice left in earnings growth to ‘solve’ the valuation problem. The source that reports these

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expectations to me does not also summarize the assumptions behind the expectations. That said, we likely need to see tax reform occur in order to reach this goal. In fact, Fidelity believes that if we do not see tax reform, we will be in recession within 18 months. I tend to agree with them. Another worry, as reported in the Wall Street Journal on September 25, is the amount of borrowings that have supported current market activity.

In absolute terms, margin debt is much higher than it was prior to previous market peaks. I think that it is more relevant to look as debt as a percentage of total market capitalization instead. How much debt is there compared to the size of the whole stock market? It's currently about 2.1%.This amount is higher than it was before the dot-com peak and much higher than before the 2007 peak. Kind of gets your attention. The bottom line is there could be levered buyers selling along with everyone else when there is a downturn.

On the positive side of things, we have an economy that is growing, companies that are earning more, workers that are enjoying higher real wages, and more cash making its way in to capital spending.

On the negative side of things, we have higher valuations, leverage starting to build, and a Federal Reserve that is beginning to implement a more restrictive monetary policy, both by raising interest rates and starting the process of reducing their balance sheet. This also underscores the importance of tax reform. The positive economic impact from tax reform could offset the restrictive nature of the Federal Reserve's new policy.

As I mentioned last quarter, predictions are difficult to make about the ultimate impact of Fed policy because its involvement both in terms of size and scope is unprecedented in history. The process of unwinding its balance sheet will create uncertainty for market through year end. We will remain diversified and attentive.

Please call with any questions or concerns.

Best regards,

Peter B. Harre, CFA