JULY 2018

BFS Wealth Management
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PERSPECTIVES

Market Recap

Year-to-date, the chart of the S&P 500[1] looks nothing like it did last year when it steadily climbed to record highs (up 19.4% for the year!) with almost record low volatility. This year volatility has returned to more normal levels, but it feels worse than it is given the relatively low volatility last year. The S&P 500 was slightly negative year-to-date at the end of Q1 (-1.2%), and it is slightly higher year-to-date as of the end of Q2 (+1.7%). However, performance across assets classes has been very uneven.

For example, bond returns are almost universally negative year-to-date, whether U.S. or international. The reason is simply rising interest rates, which depresses the value of bonds. International stocks have been weak most of the year and particularly in Q2. Their negative returns year-to-date are largely the result of an economic soft spot in Europe, trade tensions and a strengthening U.S. dollar. Commodities have overall posted slightly positive returns year-to-date on the back of rising oil prices. U.S. stocks have been the bright spot year-to-date, but even their performance has been wildly uneven, with growth stocks outperforming value stocks by 5.25% to 1.40%[2], and small-cap stocks outperforming large-cap stocks 7.0% to 1.7%.[3] It is very interesting that there has not been much talk about passive investing this year, as many active managers have performed so well in this "stock pickers market."

Rising trade tensions have generated the most market volatility this year. Markets hate uncertainty, and announcements of the pending imposition of tariffs on many products sold to us by various countries (and their subsequent retaliation) has caused great uncertainty for investors. The impact of the steel and aluminum tariffs on U.S. trading partners is mixed but remains small. Among the U.K. and other large European Union economies, exports of these goods represent less than 0.1% of those economies' gross domestic product ("GDPs"), and these exports represent only about 0.8% of Canada's GDP and about 0.3% of Mexico's. Most estimates indicate the Trump administration's newly announced duties on Chinese products should only affect a small percentage of total commerce between the world's two largest economies, and currency fluctuations have already absorbed much of the difference in relative prices.[4] The effect of announced tariffs will be minimal, and an all-out trade war is not our base case.

Forecast

Very recently, Goldman Sachs put out a new market forecast.[5] We read pieces like this frequently. We get them from several different firms. Our decades of experience helps us to analyze the different viewpoints, which benefits our clients through the way we structure their portfolios. We found our thinking to be especially in line with Goldman's piece, so we thought we would simply share it with you this quarter. What follows are meaningful excerpts edited by us for clarity (our comments are in Italics).

"For the S&P 500 we expect a modest 3% rise to our year-end target of 2850 (*a 7% gain for the year*) followed by a 5% gain in 2019 to 3000. Economic growth, oil prices, and tax rates have been better than expected in 2018 and EPS (*earnings per share*) will surge by 19% to $159. Profit growth will decelerate to 7% ($170) in 2019 followed by 5% growth to $178 in 2020. Valuation compression results when earnings growth exceeds share price gains. An environment of decelerating economic growth, a tightening Fed, a flattening yield curve, and political uncertainty is consistent with a *price/earnings multiple* (P/E) that will end 2018 at 16.8x, unchanged versus today but 10% below its January peak.

The current state of the U.S. economy is strong, and the backdrop remains supportive for equities. The Conference Board's measure of consumer confidence stands at the highest level in 15 years and only exceeded the current reading in the late 1960s and the late 1990s Tech bubble. The Small Business Optimism Index (NFIB) is at the highest level in the 45-year history of the survey, with the exception of a single reading in September 1983. Payroll growth is robust. At 3.8%, the current unemployment rate is the lowest since the late 1960s. Our economics team forecasts the jobless rate will fall to 3.3% in 2019, the lowest level since 1953.

We are boosting our S&P 500 EPS forecast for 2018 to $159 (from $150) reflecting a 19% jump from last year. Stronger-than-expected earnings in 2017 and 1Q 2018, faster US and global growth, higher oil prices, and a slightly larger boost from corporate tax reform explain the upward revision. We also lift our 2019 EPS forecast to $170 (from $158) for 7% growth, and our 2020 estimate to $178 (from $163) for 5% growth. Despite the large positive revisions, our estimates are still below the consensus bottom-up forecasts of $161, $176, and $192, respectively.

High valuation represents a risk to US equities. The S&P 500 index currently trades at the 87th percentile of historical valuation relative to the past 40 years on a variety of metrics including forward Price/Earnings, Enterprise Value/sales, Enterprise Value/EBITDA (*Earnings Before Interest, Taxes, Depreciation, and Amortization*), and Price/Book. However, stocks trade at a slight discount versus history when valued relative to interest rates.

The Federal Reserve (*the Fed*) has raised the Fed funds rate seven times since it began the current tightening cycle in December 2015. Goldman Sachs Economics forecasts two additional hikes during the second half of 2018 followed by four hikes next year. Past Fed tightening cycles have resulted in lower equity valuations but higher equity prices. During three prior hiking regimes (1994, 1999, 2004), S&P 500 P/E multiples contracted as the Fed raised rates. However, declining multiples were more than offset by strong earnings growth, resulting in rising stock prices.

Ten-year Treasury yields are forecast to climb

The Score Board

	6/30/17	YTD (Change)
Dow Jones Industrial Average*	24271.41	-1.8%
S&P 500*	2718.37	1.7%
NASDAQ Composite*	7510.30	8.8%
MSCI EAFE (USD)*	1958.64	-4.5%
Bloomberg Commodity Index	87.41	-0.9%
Barclays Aggregate Bond Index	1913.28	-1.6%
10 Yr U.S. Treasury Bond Yield	2.85%	+45 bps
30 Yr Fixed Mortgage Rate	4.52%	+60 bps
Prime Rate	5.00%	+50 bps
Crude Oil ($/barrel)	$74.15	22.7%
Gold ($/oz.)	$1,251.30	-4.2%
U.S.$/Euro	$1.17	-2.6%
Core Inflation (ex food/energy)		2.2% **
Inflation (with food/energy)		2.8% **

* Without dividends
** Unadjusted 12-mos. ended May 2017
bps (1 Basis Point = 1/100%)

UNCH (Unchanged)
Sources for Score Board and quoted statistics: WSJ, US Dept. of Labor, Federal Reserve

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Forecast (continued)

to 3.25% at year-end 2018 and 3.6% in 2019. Conventional wisdom suggests that higher interest rates result in lower equity prices. Empirically, however, during the past 20 years equity valuations and returns have often risen alongside higher interest rates.

Our economists' forecast does not include a recession during the next three years, but risks of a downturn will increase over time. Our economists' probability model suggests an 4% likelihood of recession in the next year, 18% probability in the next two years, and 32% probability in the next three years. The U.S. is currently in its ninth year of economic expansion, the second-longest in history, and has moved past most estimates of full employment. With a Fed inclined to tighten steadily, the likelihood of recession will grow in coming years (*a normal probability of a recession in any one year is 20%, so the chance of a recession in the next two years is lower than normal*).

Much attention has been given to assessing the length and depth of the next recession. Our economists' previous research finds no obvious relationship between (1) the peak output gap prior to recession and the trough of the output gap during recession, or (2) the length of expansion and the length of recession."

Portfolio Management

This quarter we added exposure to emerging market debt in most of our clients' portfolios. This is what we call an "alternative" investment, as it does not fit neatly into any other asset class that we employ. Though it is fixed income (bonds), we classify it with equities (stocks) as it behaves more like stocks than bonds. We think it is a particularly good time to add this exposure to portfolios. We are also increasing our exposure to emerging market equities.

We have been underweight these asset classes for some time. That is a good thing, as the asset classes have been under pressure with concerns about trade and a much stronger U.S. dollar recently. Emerging market debt and equity have historically been very productive asset classes, and we believe now is an opportunity to buy low so we can hopefully sell high later.

We generally increased our allocation to individual growth stocks in portfolios in which we use them – for good reason!

Talk With Us!

At the end of May, BFS Wealth Management moved into brand new offices in Irvine in order to be housed under one roof with our Institutional Services division. We had been in our Kaiser Blvd. offices in Anaheim Hills for 25 years, and we were very comfortable, but it was time for a change. Anyone who looked closely at our 25-year-old furniture or inadequate conference rooms would agree!

The move also allows us to better realize the synergies between our two divisions. We offer wealth management and financial planning services to executives and employees of companies and cities that Institutional Services advises on their retirement plans, and they have terrific investment research resources that we have been able to utilize for the benefit of our clients.

The offices are very modern and high tech. We have desks that rise or lower depending on preference, the latest greatest computers and server, TV's everywhere to help us stay on top of market news, and multiple computer screens. The location is right across the street from John Wayne Airport, and access and parking are easy. The location is much more convenient for most of our clients. We look forward to having you in for a visit soon!

1. The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market. Price return quoted.
2. The S&P 500 Growth index comprises S&P 500 stocks with above-average combinations of he ratio of earnings growth to price, sales growth, and momentum. The S&P 500 Value index comprises S&P 500 stocks with above-average combinations of book value-to-price, earnings-to-price, and sales-to-price. The weightings of both indices is by capitalization, although the weight of some stocks is divided between the Value and Growth indices.
3. The Russell 2000 is a small-cap market index of the bottom 2,000 stocks in the Russell 3000 index and is designed to serve as the benchmark for small-cap stocks in the U.S.
4. Source: Vanguard, "Is a global trade war now underway?", 6/25/18
5. Source: Goldman Sachs, "Portfolio Strategy: U.S. Equity Views", 6/20/18

Disclosures