MANAGED ASSET PORTFOLIOS

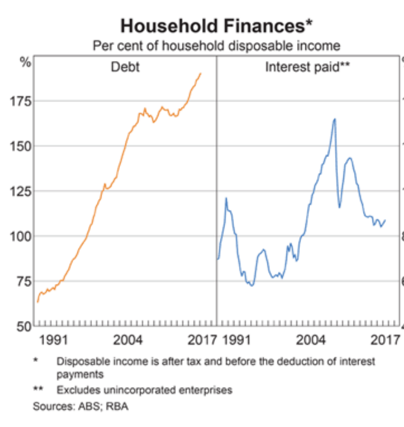
MAP VIEWS
Fourth Quarter 2017

Stocks marched higher during the third quarter, marking their eighth consecutive quarterly advance which represents the longest winning streak for U.S. stocks since 1997. In the U.S., the S&P 500 added over 4%, hitting fresh new record highs. Stock markets around the globe also had great quarters. The MSCI All Country World Index gained nearly 4.7% last quarter and hit record highs along the way. Solid earnings and expectations of tax reform provided fuel for the bulls, while lofty valuations, mounting tensions with North Korea and Washington's inability to get much done topped the list of concerns for the bears.

Interest rates picked up for the first time this year as investors revisited the "Trump-trade" aka the reflation trade. One may remember that financial and economically sensitive stocks rallied sharply post-election as investors positioned their portfolios for a stronger economic environment. A few months after the election, many of the stocks that lead the rally immediately following the election gave up those gains as investors became discouraged with the lack of progress in Washington. During the most recent quarter, information technology, energy and financials, helped push the averages into record high territory while more economically insensitive sectors, such as consumer staples, lost ground.

Despite enthusiasm for potential progress, gridlock continues to grip Washington. To date, Congress has failed to make meaningful progress on healthcare reform, tax reform or infrastructure spending. As the quarter concluded, President Trump proposed a series of tax cuts that, if implemented, would likely produce a modest bump-up in GDP. Whether the proposed tax cuts are passed as they are currently presented is unknown. A growing federal debt load that currently tops $20 trillion (or 77% of GDP) and is rising by approximately $1 million per minute may cause some politicians to pause on voting on any bill that increases government borrowing. The bond-rating firm Moody's recently echoed our concerns and noted that the proposed tax plan would likely put downward pressure on U.S. credit quality. In short, we believe that some form of tax relief will become law as the GOP is eyeing the November 2018 Congressional elections and realize that something needs to be accomplished. We however also believe, that the ultimate bill will be a weakened form of the current proposal and thereby will produce meager economic bump.

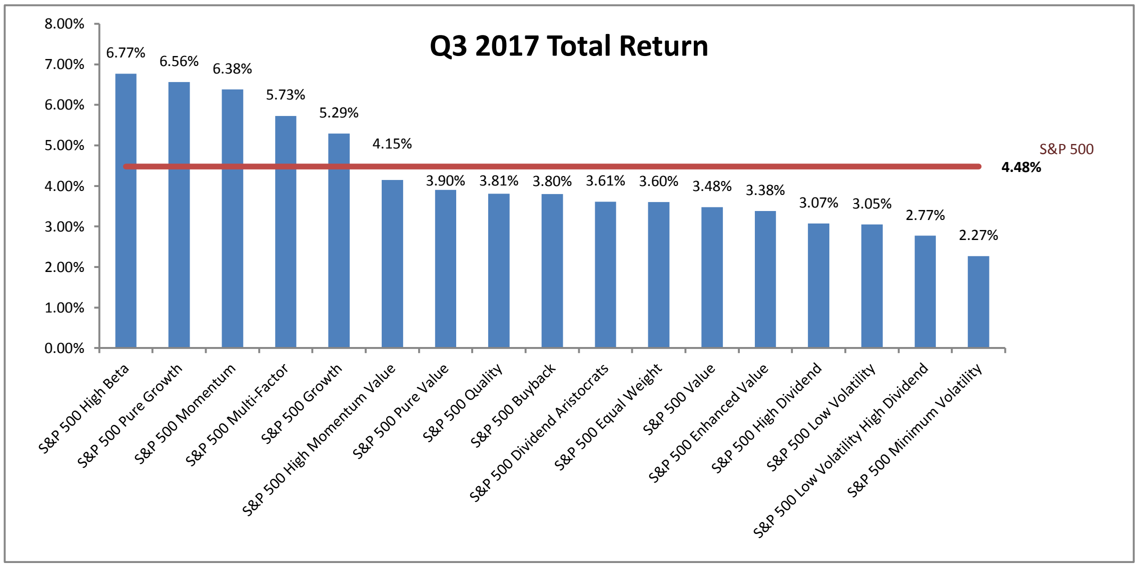
Our caution about the economic benefits of the tax relief proposal stems from two over-hanging issues that we have addressed several times in this, and other, publications. The shift from a manufacturing driven economy to a service driven one coupled with the excess amount of debt in the system continue to create an economic headwind. Further exacerbating our concerns about growth is the fact that the Fed raised rates twice in 2017 and seemingly has another rate hike scheduled in December. They also began deleveraging their balance sheet in September. Despite the Feds attempt to push rates higher, we are holding to our belief that interest rates will move only modestly higher as the strength of the underlying economy remains muted.



Interestingly, consumers have used the last decade of low interest rates to ramp up household debt. As the accompanying chart shows, debt levels have been steadily climbing while interest expense has been declining. Clearly, borrowers have enjoyed the benefits of lower interest rates.

We shudder to think what would happen if rates were to move to more normalized levels, given the growing mountain of debt.

Currently, investors are enjoying the second best bull market for stocks (both in terms of performance and duration). Only the dot-com induced rally of the 1990's tops the current Bull Run. This rally, which has stretched from March of 2009 through today, has allowed for the expansion of valuations by about 12% above historic norms. While the low interest rate and low inflationary environment certainly allow for some sort of valuation premium, we note that value today is harder to find. In the early stages of the economic recovery, we felt like kids in a candy store. We were able to buy great companies at 11 – 13 times earnings that were paying healthy dividend yields. Eight years later, value is much harder to come by. Today, the S&P 500 is trading at 21.6x trailing earnings. As evidenced by the chart below, during the most recent quarter, investors again embraced the "risk-on trades" and shunned lower volatility stocks.



Source: S&P Dow Jones Indices LLC and/or its affiliates. Data as of September 29, 2017.

We are not sounding the panic alarm; rather, we are merely suggesting that it would be prudent to use an extra degree of caution in today's stock and bond markets. Too often, crowds will continue to buy stocks that worked yesterday in hopes that they will further work today. Forty years ago, this was known as the 'greater fool' method of investing. To summarize the concept, one would buy a stock today in hopes that a greater fool would buy that same stock more expensively tomorrow. Investors embracing this investing approach would ignore stock valuations, business fundamentals, or macroeconomic environment. As is evidenced in the stock market runs that preceded dot-com bubble of the late 1990's, real estate in 2007, or energy in 2015, the crowds were hurt when there were no fools remaining. Given where we are in the economic cycle and the extraordinary duration of this bull market, now is the time to position portfolios with a defensive posture, as opposed to one that favors a risk-on environment. The bubbles outlined above all were resolved when the assets that gained the most fell the hardest. Likewise, we believe the biggest losers in the next correction will be the stocks that paced this most recent advance.

Thank you for your confidence and patronage, as both are greatly appreciated and never taken for granted.

October 6, 2017
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The information contained herein represents our views as of the date above and does not represent a recommendation by us to buy or sell any security or securities mentioned. Past performance is no guarantee of future results.