The View From Catawba

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Benchmark Returns (In Percent)

	2nd Q	Last 12 Months	Last 5 Years (annualized)
S&P 500 Index	3.1	17.9	14.6
Bar Cap U.S. Gov/Credit Intermediate Index	0.9	-0.2	1.8
Bar Cap 5 yr. Muni Index	1.3	0.4	2.1
Balanced Return 50% S&P 500 50% BarCap Inter.	2.0	8.6	8.2

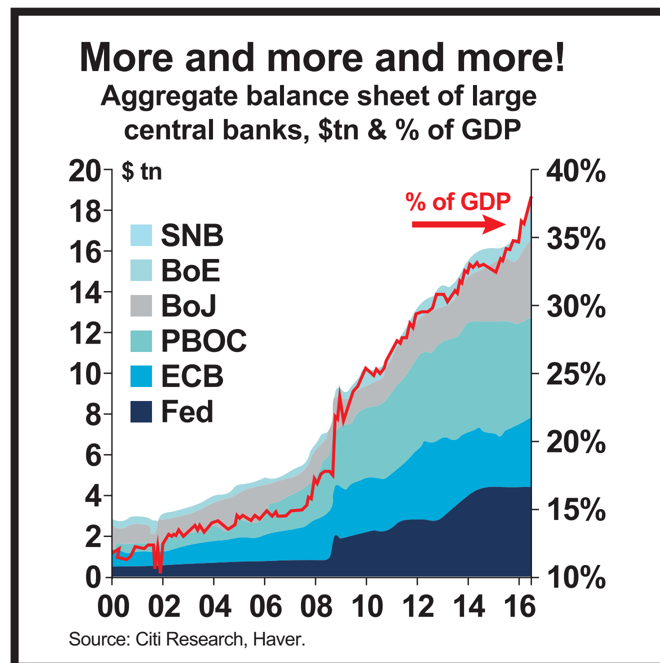
THE WALL OF WORRY

An old Wall Street adage says "The stock market climbs a wall of worry to march into bullish territory." There was no shortage of worries last quarter, even as the markets climbed to new all-time highs. Traditional value managers seem to be the most concerned, and for good reason. Equity markets seem overvalued relative to historical valuation parameters, but the financial world has changed. It is truly different this time. Ours is a brave new world wherein central bankers create money out of thin air. As there is more money chasing fewer goods, or in this case fewer stocks, the value of existing equities inflates. Old valuation metrics are no less relevant. They just need an upward adjustment to account for the creation of more money, which endows stocks with scarcity value. In order to understand our current investment dynamic one must come to grips with the idea that value is a relative concept. As central banks create new money, the existing supply of stock as a percent of overall investable funds is diminished. Therefore, stocks are bid higher based on their improved relative value. Given the ongoing influx of new central bank monies, stocks cannot be valued strictly in the context of historic valuation parameters. They must be valued with regard to the broader investment opportunity set. Fixed income capitalization has always exceeded stock market capitalization, but it has never been a higher percent of overall capitalization than it is today. Stocks have become a scarce commodity relative to bonds. Central bankers continue to create new money whereas, due to corporate buyback programs, the supply of stock has actually diminished. Global stock market capitalization represented 24% of world GDP in 2008. Stocks have more than doubled since then, but they represent only 23% of global GDP today.

Value is ultimately a function of an investor's opportunity set and their frame of reference. Central bankers have flooded the world with money and altered our frame of reference in the process. While change is worrisome, underlying valuation principals remain intact. The foundation for stock valuation has always been the interest rate backdrop and rates are close to all-time lows. The future value of corporate earnings streams are worth more when they are discounted to the present at a lower rate of interest. Historic valuation parameters are no less relevant due to central bank policies; they just require recalibration. In a world where money is created at the whim of central banks, stocks have taken on scarcity value. As central banks create more and more money, the static pool of equities is entitled to a higher valuation. Thus far, in 2017, central banks have created another $1.3 trillion thereby reinforcing the existing trend. When there is more of something, it is worth less, which in this case makes stocks worth more. The upward

adjustment in valuation metrics is worrisome relative to history. Nevertheless, it is appropriate in light of the law of supply and demand. Just as space and time are relative, so too are investment metrics. Given the ongoing creation of new money and the persistent downward bias in interest rates, it is logical for stock metrics to recalibrate higher. Higher valuation parameters are a natural consequence of low rates. Probabilities favor that this will be an enduring, quantum adjustment, which will be worried about for years, even as the market climbs its proverbial wall.

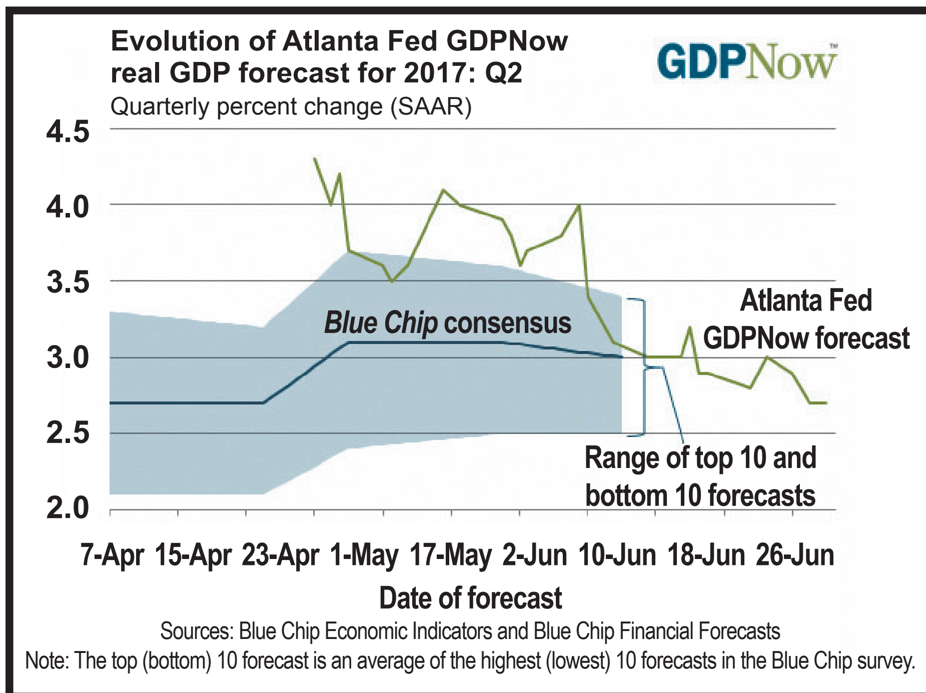
Central banks have built our present day Wall of Worry and it may endure for years to come. They have forever changed the rules of the game by flooding the world with new money and low rates. In the process, they have created a financial imbalance wherein interest rates are actually negative in some countries. Just a few years ago, the notion of an investor paying an income stream to the issuer of a bond would have been a twilight zone fantasy, but it is a reality in Europe. In today's brave new world, stock dividend yields are higher than bond yields and corporate balance sheets are immeasurably stronger than government debt. Global central banks continue to buy back their own bonds driving yields lower and infusing ever-greater quantities of money into the financial system. As governments continue to create new money, the existing universe of stocks represents an ever-smaller percentage of the total investment opportunity set, thereby making stocks all the more valuable. It is a worrisome process, but investors must recalibrate their valuation metrics. Most stock valuation levels are at the 95th percentile of richness relative to history, but fixed income alternatives are barely registering positive inflation adjusted returns. Global stock capitalization as a percent of total investment capitalization continues to shrink. Against this central bank contrived backdrop, stocks remain cheap relative to bonds. What's more, they offer higher dividend payouts. As long as corporate earnings continue to grind slowly higher, stocks will continue to climb the Wall of Worry.



Throughout financial market history there has always been something to worry about. That is why investors are often reluctant to invest in equities. It is also why, with the passage of time, more and more investors become participants as the market climbs the proverbial wall, slowly converting skeptics into believers. The markets are at new all-time highs, but countless skeptics remain on the sidelines. Probabilities favor that past will be prologue and today's Doubting Thomases will methodically convert over time. Bull markets always feel like a wall of worry - that is what sustains them. If it were not for worries, there would not be opportunity. Investing is always a worrisome endeavor. It is when investors become euphoric there is cause for concern. Despite the fact that most U.S. stock market indices have just attained new all-time highs, euphoria is in short supply, which suggests the markets will continue to climb the proverbial wall.

THE ECONOMY

While the stock market continues to make new all-time highs, the economy continues to plod forward in a steady, unspectacular manner. GDP growth during the first quarter was a lackluster 1.2%, but economists are not worried about the economy and neither is the Fed. For the last seven years, a first quarter economic slowdown has been followed by a second quarter resurgence. The Blue Chip Consensus of economic forecasters continues to predict 3% GDP growth this year. Nor are Fed economists concerned. The Atlanta Fed GDPNow forecast projects 2.7% growth for 2017. The Federal Open Market Committee forecasts 2.2% growth this year and 1.8% in 2018. While economic growth was somewhat disappointing last quarter, according to Factset, S&P 500 earnings growth was up 12.5% year over year. Since S&P 500 earnings are one of the ten components of the Leading Economic Indicator (LEI) that is a positive omen for the economy. Most of the other nine components of the LEI displayed strength as well. The recent trend in the LEI, led by the optimistic outlook of consumers and the positive up trend in the stock market, point toward continued economic growth. As the chart shows, the LEI shows no sign of weakness.



The current economic expansion has lasted ninety-six months, making it the third longest in history. Even so, with the help of the administration's proposed policies, the current recovery should set new records for longevity. New longevity records will surely be achieved if there is a swift implementation of pro-growth economic policies. The foundation of these policies are increased infrastructure and defense spending, lower taxes, and less regulation. These programs should move toward implementation before the midterm elections. The potential for new economic and market highs is diminished if such outcomes become less plausible. Swift action on the policy front is necessary to sustain consumer confidence and push the economic recovery to all-time highs. However, to assure success the president must take charge and push his programs forward. The stock market is a leading indicator, but economic reality needs to catch up to the revival of animal spirits as reflected in the stock markets. Even so, it is heartening that all of the many different stock market indices climbed the wall of worry to all-time highs last quarter. That is surely a good omen for the economy.

Our slow, prolonged economic expansion has been fueled by an ever-burgeoning debt burden. Debt is future consumption brought forward, or as some would say, consumption stolen from the future. Eventually there comes a point when debt must be repaid. From that point forward, there is going to be a period of

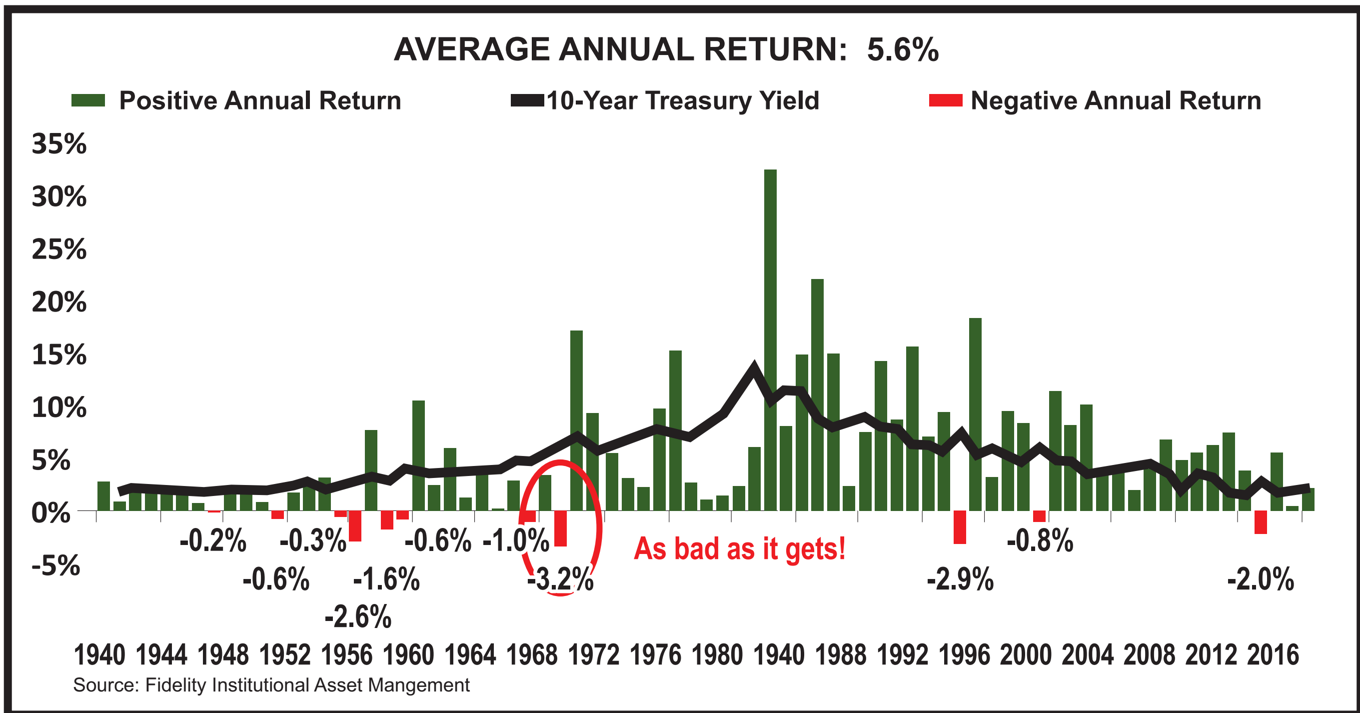
slower economic growth. That is part of the reason growth has been slow during the current expansion. Debt is future consumption denied and many debt holders are confronting the future in the here and now. That is why our economic growth trajectory has downshifted. Virtually every category of U.S. debt has ascended to all-time highs and slower growth is the natural result of indebtedness. Consumer household debt just a hit new all-time high. Therefore, it is no surprise that the recent Senior Loan Officer Survey showed slowing demand for credit cards, auto loans, and mortgages. In corporate America, commercial and industrial loans have also slowed significantly. These statistics are at odds with the idea of dynamic 3% plus GDP growth rates. They imply a period of less robust growth, but they do not imply the end of an economic cycle. They do affirm a high probability of low interest rates for some time to come.

THE BOND MARKET

The wall of worry notion is just as appropriate to bonds. Relative to their benchmarks, most bond managers are under invested, which suggests that they are up against the proverbial wall. Recent volatility has prompted fixed income managers to lower portfolio duration. Duration relates to portfolio sensitivity to interest rate movements. When rates resume a downward bias, under invested bond managers will reposition for lower rates lending impetus to higher bond prices. Considering the less robust economic backdrop, further Fed Fund Rate hikes are less likely. Probabilities favor that the rate hike cycle as measured by the Fed Funds rate is already close to, if not at, their cycle high. The Fed is on record saying that the current neutral rate, meaning the short-term rate that is neither stimulative nor contractionary, is nowhere as high as the historical level. Over time and through market cycles the Fed Funds Rate has averaged about 4%, but the Fed believes the new neutral rate is half the old, implying that Fed funds rate would not rise above 2%. The current rate just inched up a quarter percent to the 1.0-1.25% range last month. Even in the face of Fed Fund rate hikes, longer-term yields fell last quarter. In the wake of the election, based on the reflationary implications of the president's economic proposals, yields rose too high. Investors embraced the idea that the economy would improve markedly, which would cause inflation to rise and bond prices to fall. Increased political uncertainty will likely delay economic stimulus thereby diminishing the near term prospects for higher rates. Post-election optimism is fading and the ten-year bond yield has fallen from its mid-March high of 2.62% to 2.30% at quarter's end. The Fed may be tightening, but inflation is faltering and the economy is not terribly robust. They will not take rates much higher in 2017.

Odds are that rates will be lower for longer and we will not see the aggressive rate hike programs experienced in the past. Historical perspective should put bond investor fears at rest. The absolute worst calendar year the bond market aggregate index has experienced since 1940 was in 1969, when the bond market fell a little over 3%. The recent volatility in bond yields has been over hyped. Besides, history indicates that, even in worst-case scenarios, laddered bond portfolios benefit from rising rates as maturing bonds reinvest at higher rates of interest. Although the Fed has raised short-term rates, the yield curve has actually flattened. Short-term rates are up, but longer rates have retreated. Bond bears got overexcited last quarter; bond investors are not in jeopardy.

The yield curve flattening is a precursor to slower economic growth, which is counter to the Fed's goal. This implies that their rate normalization program has just about run its course. Studies of past interest rate cycles indicate that the longer



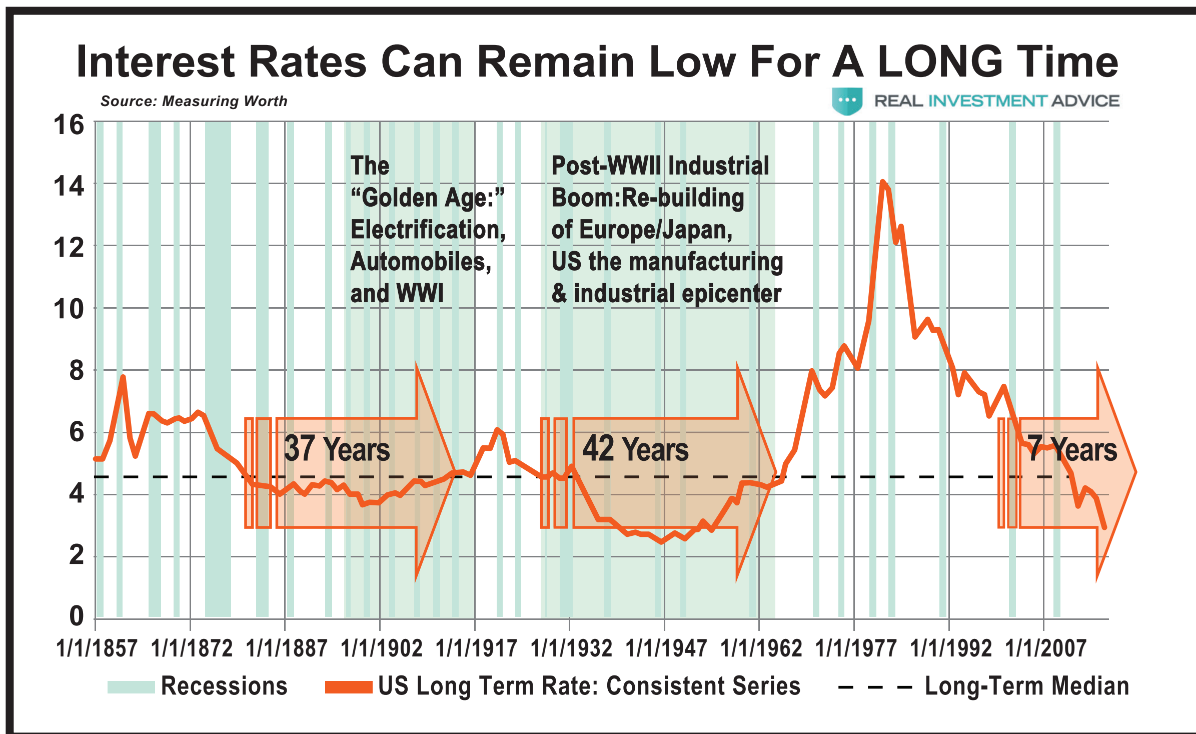
the bull or bear market, the longer the peaking or bottoming process takes to play out. Rates have risen somewhat off their lows, but the "lower for longer" mantra still seems appropriate.

The bond market is not in jeopardy. Dynamic economic growth coupled with higher inflation is not a near term prospect. The outlook is for modest economic growth coupled with ongoing disinflationary pressures. The Fed is raising rates into an economy that is not accelerating and may have already plateaued. Furthermore, the Federal Reserve is the only central bank in the world that has pushed rates higher; we already have the highest rates in the world. To close the case, prospects for a more robust recovery have diminished. Mounting economic uncertainty implies slower growth and lower yields. The presidential election marked an attitudinal change that unleashed the proverbial animal spirits in investors. However, the abrupt upward move in rates, based on the reflationary implications of the election, is no longer valid against the backdrop of post-election realities. Fading prospects of tax reform and fiscal stimulus have shifted momentum in favor of lower yields.

The bond market has been climbing a wall of worry since 1980. Fears of a bond bear market are greatly exaggerated. As economic and market fundamentals support a continued decline in bond yields, lower rates will prevail. In fact, the Fed's tightening program is close to running its course. It is interesting to note that some fixed income strategists speculate that the recent tightening program had an unusual motivation. They surmise that the Fed had already reduced rates to zero and was up against their own worrying wall. The Fed needed to raise rates just so they would have the wherewithal to lower them in the event of an economic slowdown. Given how low interest rates have been, if recessionary potential were to develop, they would have a limited ability to cut rates as a remedy.

The Fed will not take rates much higher, nor will they normalize their balance sheet through Quantitative Tightening. By selling some of the $4.5 trillion in bonds they accumulated during QE, they would raise rates and jeopardize what is already the third longest economic recovery in modern history. A disruptive pivot away from

unconventional monetary policy does not seem possible against the existing economic backdrop. The Fed has backed itself into the proverbial corner and the implication is that rates will be lower for longer. As the chart depicting U.S. long term rates illustrates, interest rates can remain low for a long time.



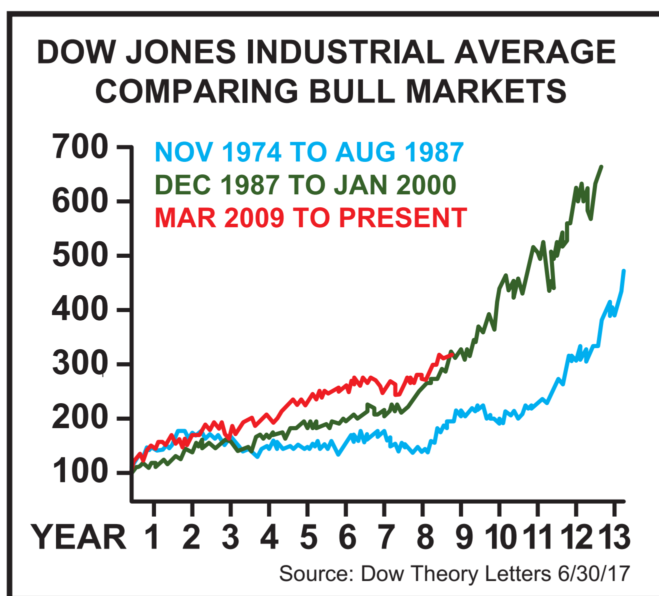
STOCKS

As bull markets go, this is not the longest, the best performing, or even the most expensive. The current market continues to move ever higher in a slow, steady-state manner. Usually that is a good sign because bull markets go out with a bang, not a whimper. They typically die of fright not of old age. Right now, the fear of missing future gains is rising. An ever-increasing number of new highs throughout virtually all indices is stoking that fear. Even the laggard transportation and small cap indices made new highs late in the quarter. Market history and investor psychology suggest that the fear of missing out will grow with every new uptick. Absolute valuations are high relative to history, but valuation metrics have never been good timing indicators. Furthermore, given low rates and recent bond market volatility, relative valuations remain compelling. A slight uptick in interest rates does not nullify the relative return potential of stocks versus bonds. Ongoing improvement on the earnings front helps the cause as well. Second quarter earnings reports should reflect an 8% year over year increase in earnings per share. EPS growth should hit double digits later this year.

Valuations are not attractive relative to history, but they are rational relative to the overall financial environment. The Adaptive Market Hypothesis (AMH) is a new version of market theory, which seems appropriate to the changed financial realities of our time. The basis of this theory is simple. Since the 2008 crisis, financial markets have been subject to excessive liquidity, which requires an

adaptive response. According to the new theory, the profit opportunities in a market are analogous to the amount of food and water in a given ecology. The fewer resources present, the more fierce the competition. More and more newly created central bank money is looking for a reasonable return and fixed income securities offer little in the way of sustenance. The international ecosystem is flush with cash and that liquidity is leaking into the equity markets as an adaptive response to remarkable changes in the financial ecosystem. The AMH implies that risk/reward relationships vary over time and that the best way of achieving a consistent level of return is to adapt to changing market conditions. In the current environment, fixed income securities offer lower inflation adjusted returns, whereas stocks offer better dividend yields along with the prospect for earnings growth. Theories make the most sense when they jive with the real world. Given the current financial backdrop, the AMH concept makes sense.

Wall Street bears are drawing conclusions based on models that do not adjust for central bank intervention. Old theories are firmly entrenched and well grounded, but they do not account for relentless central bank interference in the global markets. The total market capitalization of U. S. listed stocks is now $25 trillion, but central banks have created $18 trillion out of thin air. Most of that money has not found its way into actual economic projects. In fact, a good portion of that newly created money is still searching for a decent return. Most of it will find its way into the financial markets. These newly created funds reinforce the case for a super bull run that climbs the ultimate wall of worry. Given central bank money creation and human nature, it will be difficult for investors to maintain conviction that is counter to prevailing market trends. The siren song of new market highs and crowd psychology will ultimately drive investors into the market. Bulls are still in charge. A bullish bias remains appropriate. The dynamic "fear of missing out" stage of the bull market is yet to come. Relative to past secular bull markets the current March 2009 Bull Market could last considerably longer and rise substantially higher.



A stock market hitting new all-time highs is clearly in a secular bull market. Almost 23% of the S&P 500 stocks achieved all-time highs last quarter, as did six of the nine sector groups, yet room for improvement persists. In fact, the top ten contributors to the S&P 500, mostly the so-called FAANG (Facebook, Amazon, Apple, Netflix, and Google) stocks accounted for 47% of the S&P 500 gains this year. Past bull market patterns indicate that rank and file stocks play catch-up before a bull market runs its course. Past patterns also indicate that speculative blow off phases occur before a bull market ends. Few investors doubt that we are in a confirmed bull and the bullish excitement phase, the madness of crowds phase, is still ahead of us. Overtime, even die-hard fundamental investors come to accept the fact that the first rules of investing are "don't fight the tape" and "make the trend your friend." The current market continues to move ever higher in a slow, steady-state manner. Usually that is a good sign because bull markets go out with a bang, not a whimper. The best timing tool has always been the leadership stocks. The FAANG stocks are ascending to all-time highs and the rank and file will follow.

VIEW FROM CATAWBA

- Investing is always worrisome. Throughout financial market history there has always been something to worry about. That is why investors are reluctant to invest in equities. It is also why, with the passage of time, more and more investors become participants as the market climbs the proverbial wall, slowly converting skeptics into believers.

- The current economic expansion has lasted 96 months, making it the third longest in modern history. Even so, with the help of the administration's proposed policies, the current recovery should set new records for longevity.

- Stocks have become a scarce commodity relative to bonds. Central bankers continue to create new money whereas, due to corporate buyback programs, the supply of stock has actually diminished. Higher valuation parameters are a natural consequence of low rates.

- The recent volatility in bond yields has been over hyped. Besides, history indicates that, even in worst-case scenarios, laddered bond portfolios benefit from rising rates as maturing bonds reinvest at higher rates of interest.

- The bond market has been climbing a wall of worry since 1980. An examination of past interest rate cycles indicates that the longer the bull or bear market, the longer the peaking or troughing process takes to play out. Fears of a bond bear market are greatly exaggerated.

- The current stock market continues to move ever higher in a slow, steady-state manner. Usually that is a good sign because bull markets go out with bang, not a whimper. Ongoing improvement in S&P 500 earnings is a positive. Second quarter earnings reports should reflect an 8% year over year increase in earnings per share and EPS growth should hit double digits later this year.

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"Formula for success: rise early, work hard, strike oil."

– J. Paul Getty

Summer Jobs

The rate of teenage participation in the job market has hit a forty-year low of 43.2%. Jobs in retail sales have contracted offering fewer opportunities for young job seekers. With over 4,000 major store closings announced in 2017, there are fewer openings available for retail workers of all ages. Teenagers have become one more victim of the internet incursion into retailing.

- Moise, Imani. 2017, May 24. *The Wall Street Journal*. "Teens Miss Out on Summer Jobs."
- Wahba, Phil. 2017, June 15. *Fortune*. "The Death of Retail is Greatly Exaggerated."

Credit Scores

Credit Scores hit a record high! For the first time, the average national FICO score has reached 700, up from the low of 686 achieved in the housing crisis of 2008. FICO scores range from 300 to 850. Scores above 800 are exceptional and credit applications at this level will receive an easy approval. On the other hand, consumers with scores below 580 are considered subprime borrowers and may have difficulty getting credit.

The improvement in the numbers of employed, higher home values, and record stock prices all contribute to the spike in FICO scores. The passage of time has also played a role as foreclosures and bankruptcies from the Great Recession are falling off of credit reports.

- Androtis, AnnaMaria. 2017, May 29. *The Wall Street Journal*. "Credit Scores Hit Record High as Recession Wounds Heal."
- Yardeni, Dr. Edward. 2017, May 4. www.yardeni.com. "Chart Collection for Morning Briefing."
- www.experian.com. "What are the FICO Score Ranges?"

Tax Debate

As Congress wrangles over amending the U.S. tax code, owners of pass-through companies (S corporations, limited liability corporations, partnerships, and sole proprietorships) are watching with much hopefulness. Discussions focused on allowing these companies to pay a new corporate tax rate of between 15% and 25% rather than the top rate of 39.6% for individual taxpayers are very encouraging. 95% of all business tax returns and 60% of net business income generated by U.S. companies are accounted for by pass-through entities. The devil is in the details regarding replacing the higher level of tax revenue that would be lost.

- Hube, Karen. 2017, June 19. Barron's Penta. "Brutal Battle Coming Over Pass-Through Tax Cut."

Shrinking Markets

The number of domestic companies listed on U.S. stock exchanges has fallen to a forty year low. From 7355 at the peak in 1997, the number of listed firms fell to 3556 in 2016. Merger and acquisition activity, as well as the surge in U.S private equity likely explains the dramatic fall off.

- www.politicalcalculations.blogspot.com. 2016, September 21. "The Shrinking U.S. Stock Market."
- *The WEEK*. 2017, July 14. The Bottom Line.

The Oracle of Omaha

The Buffet indicator, offered by Warren Buffett in a Fortune Magazine interview, is within hailing distance of the all-time high reached in 2000. The simple ratio of the stock market capitalization of domestic companies divided by U.S. GDP captures a great deal of the relative price attractiveness of U.S. stocks.

Using the Wilshire 5000 group of stocks, the ratio tracked from the high of 136.5% in 2000 to the low of 56.8% in 2009 giving investors quite a ride. The ratio has rebounded to 127.6% today – second highest since 1950.

- Mislinski, Jim. 2017, July 5. *Advisor Perspectives, Inc.* "Market Cap to GDP: An Updated Look at the Buffett Valuation Indicator."

Revolutionary Change

"For the past eight years, the U.S. economy has expanded on a wave of new technology. Fracking, 3-D printing, composite materials, and mapping the genome are huge. Bandwidth, the cloud, apps, smartphones, and tablets are bigger. Technology has never moved this fast."

- Wesbury, Brian. 2017, April 10. *Economic Commentary*. "This Recovery Isn't Boom or Bust."

"In times of rapid change, experience could be your worst enemy."

– J. Paul Getty

Going, Going, Gone…

The month of June produced a record number of home runs in Major League Baseball. 1,101 "dingers" were recorded last month, surpassing the 1,069 tallied in May of 2000. According to Hall of Fame pitcher and current game analyst, Jim Palmer, hard bats (maple vs. ash) and harder baseballs have contributed to this record performance.

- Associated Press. 2017, July 2. "MLB record: 1,101 homers hit in June."

Anniversary

June 2017 saw Catawba Capital Management celebrate its 25th anniversary as a SEC Registered Investment Adviser. The ten people at Catawba manage over $1.0 billion for their clients.