Making Sense of Finance

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Second Quarter 2017 Review

STOCK MARKET

The rally in the U.S. stock market persisted in the second quarter, with all major indices gaining. The NASDAQ composite continued to increase more than the other widely followed indexes, with a gain of nearly 4% versus the S & P 500 increase of almost 3% for the quarter. This brought the total NASDAQ year to date increase to 14% as technology stocks lead the way in the market so far this year. This far surpasses the approximate 8% gains year to date for the S & P 500 and Dow Jones Industrial Average, though these also are considerable increases. Many seem to question why the market continues to rise. A simple answer might be that earnings continue to rise. The S & P 500 trailing P/E (price/earnings) ratio is currently 23.8. Last year at this time it was 24.1. Meaning valuations have not changed as far as the relationship of stock prices to earnings, even though the price of stocks have gone up over the last twelve months. Earnings have risen, in the aggregate, in lock step with stock prices. Within this rising market, volatility remains low, as mentioned in our last newsletter. In fact in recent months, the daily fluctuations in currencies have been greater than that of stocks (as measured by the movement in the S&P 500). This is typically not the case which makes the media suggest complacency on the part of investors. However it could be nothing more than a fairly low interest rate environment with rising earnings allowing for investors to not over react to other news headlines.

Technology stocks may be the leaders so far this year, but last quarter medical equipment and medical supply stocks were among the best performing industry groups. The aerospace sector also outperformed the general market. There definitely is sector rotation as some industry groups did significantly worse than the market. Same as last quarter, coal stocks and retail REITs continued to lose ground. Also not surprisingly apparel retail stocks declined. The Retail sector has been fighting an uphill battle as Amazon.com seems to continue to put its mark on every retail segment. Telecommunication stocks also were among the losers last quarter.

This year has been a good one for the most part for foreign stock markets. Some of the best performing markets have been emerging markets such as Poland, Argentina, and Turkey. The MSCI EAFE index which measures developed stock

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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markets again had a larger increase in the second quarter than its U.S. counterparts with an increase of over 5% in U.S. dollar terms. However, this same index, when measured in local currency terms, only gained 1.7% in the previous quarter. In the second quarter the U.S. dollar had weakened against many foreign currencies. This is looked upon favorably by the current administration as a means of making U.S exports globally more competitive.

BOND MARKET

Overall, the aggregate U.S. bond market increased 1.6% on a total return basis in the second quarter as measured by Barclays Aggregate Bond Index, a measure of investment grade bonds in the United States. Bonds continued to lag stocks for the last quarter and year to date. Short and intermediate term corporate bonds posted modest gains for the quarter as did municipal bonds. High yield (non-investment grade bonds) had the best total returns, largely due to their higher coupon rates rather than price gains.

The U.S. Treasury market repeated more of the same in the second quarter: short rates went up and long rates declined. This in turn flattened the yield curve even more, not helping bank profits. The Federal Reserve had raised the Fed Fund target rate for the second time this year in mid-June by 0.25%. Again this was not unexpected. According to the Federal Reserve, the bond market should be prepared for one more rate hike this year and three more next year. A three month Treasury bill now yields more than 1.00%, a far cry from a yield of .01% which we saw as recently as the fall of 2015 for the same term. The yield on a 10 Year Treasury is currently 2.3%, which although is considered low, is actually higher than most other developed country government bond yields, with the exception of Australia. Japan in particular is still extremely low, with their 10 year bond yielding .08%. Most of the purchasers of these Japanese bonds are the Japanese people themselves who seem to be content with these extremely low yields. The two and five year Japanese bond yields are even harder to comprehend since those yields are negative!

OUTLOOK

With the equity markets reaching new highs, human nature inevitably asks, how high can it go? The fact is we invest because we think that corporate profits will continue to grow. Can Apple only grow to $780 billion in value and that's it? Why wasn't it too big at $100 billion or $500 billion? The truth is, as long as there is potential for greater corporate profits, stocks can continue increasing in value. I often hear about people moving out of the market because its reached "new highs". If they did that over the last 50 years, they would have been wrong 80% of the time at the end of the year. From 1967 to 2017, the market was up 40 years and down only 10. Over longer periods of time, the market has been up 67% of the time. More importantly, in 1967, the S&P 500 index was at 87 and ended 2016 at 2,239. If you got out at every new high during this period, you would have been wrong for 2,152 points or 2,474% (24.75x). Unfortunately, no one can call a top consistently but it shouldn't matter. We are investors, are we not? Investors are always in it for the long haul and we define that in years if not decades. More importantly, down markets should be viewed as times of opportunity not times to be feared.

We reiterate that we see rising rates as a headwind, but our view of each asset class remains the same as it has historically been with Equities (stocks) most favorably viewed, followed by Real Estate, and followed by fixed income securities (bonds, preferred stock). Higher interest rates from these historical lows actually signify a stronger economy, in our opinion. While bonds tend to be more stable, they can still be volatile if rates rise or fall suddenly. They are our least favorite asset class because of their lack of ability to increase payouts to offset inflation.

Regarding the geo-political environment; worries are ever present, but let us put it in perspective. For about 45 years we were in a Cold War with the Soviet Union. Concerns about North Korea are real, but at least the Russians had working nuclear missiles (we assume), and thousands of them. The general consensus is that North Korea doesn't even have ONE. Also, our new President is quite the showman and has seemingly no filter. He has been compared to Richard Nixon quite frequently. The story of his presidency is yet to unfold but even with all the controversy, volatility in the stock market has not been this low in over a decade. I think most people would agree that the combination of Donald Trump and Kim Jong Un pales in comparison to the Cold War and Richard Nixon, and still between 1967 to 2017, the stock market was up 80% of the time and up 2,474%. Remember that if you get out, you miss out.

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