Quarterly Insights **July 2017**

Climbing the Wall of Worry

With a seemingly endless stream of bothersome headlines continuing to emerge, the stock market thus far seems to be again climbing "The Wall of Worry." The implicit message is that investors believe today's issues will ultimately be resolved without a negative impact to the economy. Fueled by optimism of lower taxes, increased government spending, and lower regulations, the market appears to be pricing in not just a steady environment, but real growth. In the first quarter GDP clocked in at 1.2%, unemployment continued to drop to 4.3%, and inflation ran at 2.2%. While positive, the numbers are slightly disappointing which has some starting to wonder if the market has gotten ahead of the economy.

In April, we got a glimpse at what could ultimately provide the growth investors are seeking when President Trump unveiled his plan for broad tax reform. A 15% tax rate for all businesses, lower individual rates, increased standard deduction for middle-income households, and the repeal of estate and alternative minimum taxes could shift the economic growth into a higher gear. The plan also calls to reduce the number of tax brackets for individuals from seven to three, greatly simplifying the tax code.

Cheered by the markets and businesses, the release was short on technical details of how to pay for the cuts and was quickly panned by Democrats and budget hawks who believe it would add trillions in debt. It's clear the path to tax reform will not be easy, but we are encouraged by the spirit of a pro-business and simplified tax code.

While the economy continues to grind along, one area of concern is the consumer, who remains the main driver of economic growth. Real personal consumption grew by just 0.6% in the first quarter, down from 3.5% in the fourth quarter of last year. The drop was attributed to two areas: 1) reduced spending on motor vehicles, and 2) reduced spending on utilities following unseasonably warm temperatures. Real disposable income grew at 1% during the quarter so the hope is that spending will rebound and the slowdown will prove to be temporary.

One secular shift that appears more permanent is how consumers shop. American retail may be at a historic tipping point. E-commerce, led by Amazon, has been growing over the past three years at an annual rate of $40 billion. The results of this shift are significant. From October of 2016 to April of 2017 roughly 89,000 Americans in general merchandise stores were laid off (more than all of the people employed in the United States coal industry). It's also worth noting about one out of every ten Americans work in the retail industry. Over time, it is our belief that the labor market will rationalize itself; however, in the near-term there will likely be friction as workers shift into other industries.

Amazon is part of a group commonly referred to by the acronym "FAANG" (Facebook, Amazon, Apple, Netflix, and Google) that have a history of disrupting industries and usurping competitors that were slow or unable to adapt. The speed and scale at which this group has evolved has been remarkable. For instance, in 1998 Amazon sold books online while today it is seeking to become the predominant seller of everything you buy. Even grocers, once thought to be Amazon-proof, are under pressure with the announcement of its acquisition of Whole Foods Market in June.

The growth of these companies has been rewarded through large increases in their stock prices. The FAANGs now represent 4 of the top 10 largest companies in the S&P 500 (Netflix is the only one not in the top 10). The performance of these stocks has been a large driver of the overall market's move higher over the past few years.

However, the valuations of the group measured by P/E ratios have also expanded. Investors in Amazon, particularly, have given the company a pass on showing profits today in exchange for the promise of even greater growth of future profits. This dynamic has allowed Amazon to have a virtuous cycle of expanding into different industries by charging lower prices and capturing large amounts of market share from competitors. What will ultimately change this dynamic is still unclear to us. Traditionally, anti-trust was based on higher prices or lower selection for consumers; precisely the opposite of what Amazon has provided.

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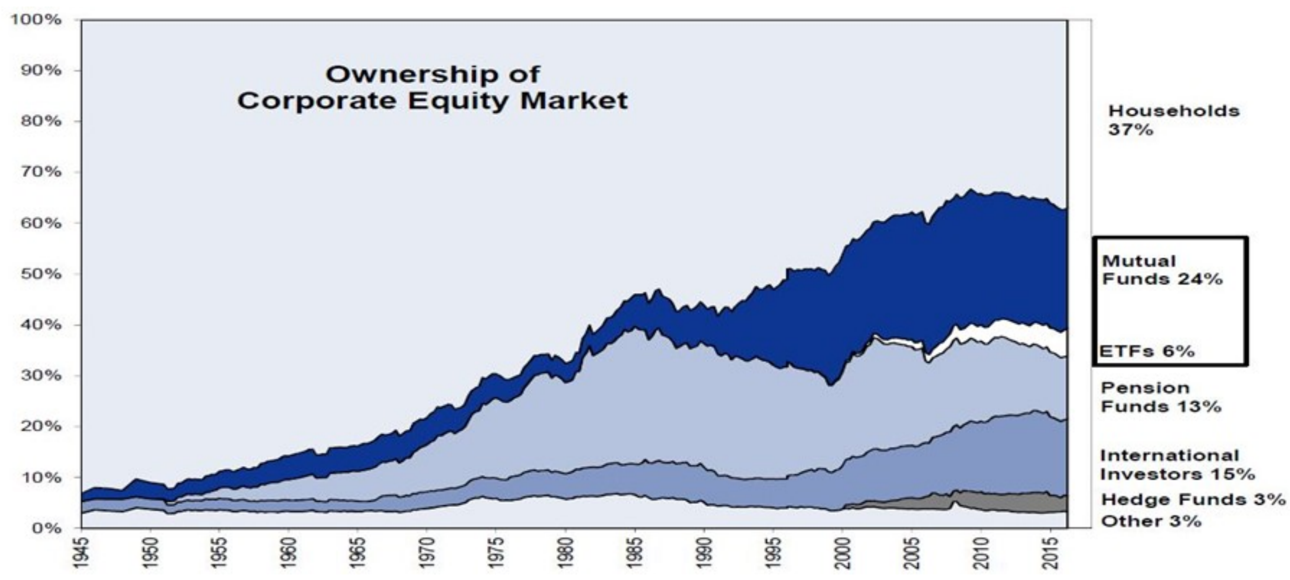
An asset class that has experienced unbridled enthusiasm during the quarter is cryptocurrencies. There are now over 800 varieties in existence with the most well-known being Bitcoin. Bitcoin is a digital and global money system using blockchain technology that works without a central authority. Since 2010, it has grown exponentially in value and now has a market capitalization of $33B. The price of a Bitcoin recently topped $3,000/coin leading to some eye-popping returns given that just five years ago it could be bought for approximately $5/coin or a 60,000% return (albeit with 81% sell off along the way). Proponents of cryptocurrencies view them as the revolutionary currency systems of the future. Critics see them as just the latest bubble that will eventually pop as speculators ultimately rush for the exits. While there is merit to the technology backing Bitcoin, meteoric price rises often move well ahead of fundamental value. It is also unclear which of the 800+ cryptocurrencies (if any) will someday emerge the winner(s).

Our investment outlook hasn't changed significantly during the quarter as we are still cautiously optimistic on the economy. Famed investor Peter Lynch once said, "Far more money has been lost by investors preparing for recessions or trying to anticipate them than has been lost in the corrections themselves." It is with this thought in mind that we continue to maintain an appropriate balance within our portfolios.—Jerry McQueen & Todd Fungard

Rise of Passive Investing With ETFs

Passive investing through the use of Exchange Traded Funds (ETFs) is increasing dramatically, helping to drive share prices higher and extending the U.S. stock market rally. ETFs are baskets of stocks or bonds that are passively managed to various market indexes with low management fees. ETFs purchased $98 billion in U.S. stocks during the first three months of this year, putting them on pace to surpass the last two years' combined total of $362 billion. As shown in the chart below, ETFs owned 6% of the U.S. stock market as of the end of the first quarter; their highest level on record.



Source: Federal Reserve Board and Goldman Sachs Global Investment Research

The rise of passive investing has accelerated over the last ten years as actively-managed funds have struggled to outperform their benchmark indexes. As shown below, $3.1 trillion has flowed into passive stock and bond funds while $1.3 trillion has flowed out of actively-managed funds since 2007.

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Cumulative active vs. passive flows to bond & equity funds ($ trillions)

Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

Active managers argue that the push into passive investing shifts the price movements towards index inclusion rather than focusing on economic fundamentals of the underlying stocks. This rise in indexation has clearly coincided with a long period of rising stock prices. Whether this push towards passive investing will have the opposite impact if markets turn negative remains to be seen. We continue to believe that a mix of passive and active investments should form the core components of a properly diversified portfolio.—Bill Schultz

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McQueen, Ball & Associates, Inc.

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