The Longer View

COMMENTS AND OUTLOOKS FROM LONGER INVESTMENTS INCORPORATED

July 3, 2017

In the first half of 2017, the markets delivered positive results, although we saw considerable divergence among market sector returns. Consider these first-half performances:

Table 1

Index	**2017 First-Half Return**
S&P 500 (cash basis)	8.2%
CRSP U.S. Large-Cap Value Index	3.8%
S&P Small-Cap 600 Value Index	0.9%
Morningstar Dividend Yield Focus Index	3.0%
S&P Energy Index	-14.1%
S&P Technology Index	16.8%

International stock markets were stable; they outperformed the U.S. stock market. Europe was up 12.5%, as measured by the MSCI Pan-Euro Index. Asia was up 18.3%, as measured by the MSCI AC Asia ex Japan Index.

The Bond Market

Bonds returned 1.1%, as measured by the Barclay's Bond Fund 1- to 5-Year Government/Corporate Index, and they returned 2.3%, as measured by the Barclay's Aggregate Bond Index.

In December 2016, the Federal Reserve (the Fed) raised rates by 0.25%. So far in 2017, the Fed has raised rates twice, in March and in June, by 0.25% each time. The Fed is responding to tightening labor markets (4.3% unemployment in May), and the rising inflationary pressures that point toward the Fed's target of 2% CPI (Consumer Price Index) growth this year. We anticipate one more hike, possibly in December. At this time, we don't expect a September hike. Although short-term rates, which are under the Fed's control, increased this year, long-term rates declined. The result was a flattening of the yield curve, as shown in Table 2 and in Chart A on page 2.

Table 2

U.S. Treasury Yield Curve

Maturity	**12/31/16**	**6/30/17**
Two-Year	1.19%	1.38%
10-Year	2.43%	2.30%
30-Year	3.05%	2.83%

In the past, we have traded the long end of the yield curve by means of a 20+year U.S. Treasury exchange-traded fund. We do not currently own any long-term bond funds. Bond prices decline as yields rise, and prices increase as yields decline. At this point in the cycle, there is some risk of price decline if rates increase. Long-term rates increased sharply after the November election, and stocks rallied on prospects that a new economic policy would lead to growth. But when legislative delays cast doubt over timely implementation of those economic growth initiatives, long-term rates fell, even while short-term rates were being raised by the Fed. The result is what we call a flattening of the yield curve. In this volatile government policy environment, we will be cautious with the term structure of our bond market investments. We are prepared to act when the landscape is

Chart A

Ten-Year Yield Minus Two-Year Yield
U.S. Treasury Spread (basis points)

Source: Evercore ISI (6/26/17)

more discernible and economic projections are more reliable. Regardless of maturity, we currently hold only investment-grade bonds.

The Stock Market

The U.S. stock market delivered a positive first-half return, although there were dramatic differences by sector and style. (See Table 1.) Technology was the strongest performer. The FANG stocks (Facebook, Amazon, Netflix, and Google) delivered more than 25% of the S&P 500 return. The concentration of a few hot stocks affecting total index return so profoundly is rarely seen.

Immediately after the November election, prospects were brighter (see our Nov. 16, 2016, newsletter). Investors anticipated a new economic growth plan based upon tax reform, repatriation of corporate assets held abroad, and a $300 billion infrastructure investment program. In addition, there were expectations that the Affordable Care Act (the ACA, or Obamacare) would be repealed or replaced. This was the platform upon which many Republicans ran. Optimism that these campaign promises would be kept was bolstered by one-party control of the House, the Senate, and the White House — something not seen since 2008, when President Barack Obama was first elected.

So far in 2017, the entire agenda has been held up by the uncertain progress of the "repeal and replace" health care initiative. The vote on the first House draft was cancelled when it failed to get wide support. After weeks of meetings and changes, the House passed a new overhauled bill, only to see it rejected by the Republican-controlled Senate.

Next, a committee of 13 senators, meeting behind closed doors, came up with its own version of "repeal and replace." The Senate bill, unveiled on June 22, also failed to attract the necessary number of votes. Party solidarity could have carried it, but five Republican senators publicly declared that they would not support it. On June 30, the Senate majority leader announced the issue would not be voted on again before the Fourth of July recess. As this newsletter is being written, we don't know whether another bill will come to the floor in the two and a half weeks between the end of the July break and the August recess. Early in July, President Trump suggested in a tweet that Republicans should just repeal Obamacare, and deal with replacement at a later date. This outcome seems unlikely, due to the chaos it could cause, but the president's comment does add another layer of uncertainty.

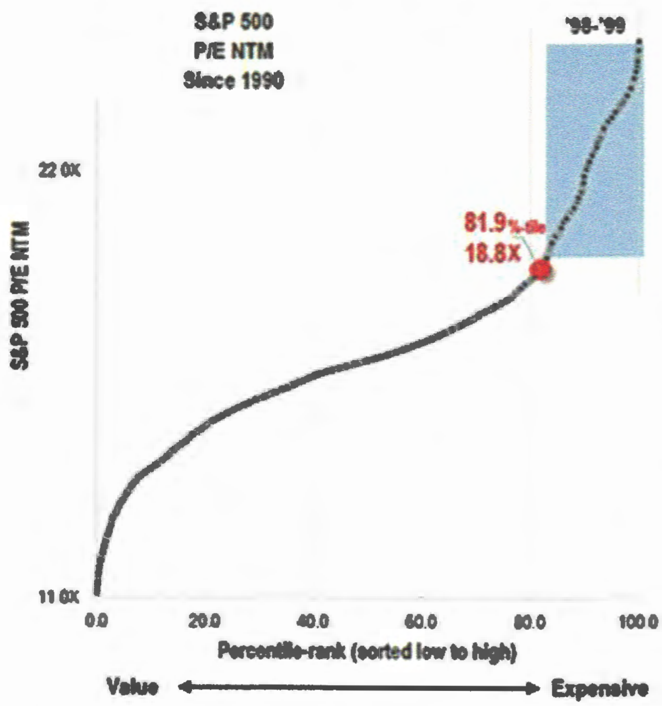
This is all important because it seems unlikely that any other agenda items will be addressed until the health care bill is finalized. This is not a political commentary, rather it is a market observation. Investors are growing impatient. They are beginning to doubt that the "growth agenda" will be underway before 2018. This pushes back its expected positive impact on real gross domestic product (GDP) growth. Last week, the International Monetary Fund (IMF) cut its U.S. economic growth forecasts for both 2017 and 2018 to 2.1%; its prior forecasts were 2.3% for 2017 and 2.5% for 2018. Citing a lack of details on the U.S. administration's still evolving policy plans, the IMF decided to remove the assumed stimulus from its forecasts. Some of the institutional research services we use have also begun to scale back their economic growth projections for 2017 and the first half of 2018.

Strategy

We continue to invest in quality growth companies that meet our valuation requirements, that pay a good dividend, and that display a strong balance sheet (with conservative debt structure). At midyear, our performance was similar to the performance of the large-cap value index and the high-dividend index. We are increasingly concerned about the volatility and narrowing leadership (fewer participating stocks) on the recent new market highs. There may be significant policy risk as the legislative agenda unfolds — or fails to. The outcome will affect all of the variables that make up stock market valuation — economic growth, productivity, inflation, taxes, earnings, and interest rates. The stock market's valuation is such that there is not a lot of room for disappointment. Uncertainty could bring about either a reduction in the earnings estimates for 2018 or the valuation attached to those earnings. As shown in Chart B, valuation on the S&P 500 is now above the 80th percentile in historical terms, meaning stock market valuation at these levels is not cheap. For now, we adhere to our disciplines, which include stop-loss orders on recent equity purchases. Such orders can generate more buy-and-sell volatility, but they protect capital and give us the flexibility to reinvest cash balances where we find value.

Chart B

Rank of S&P 500 P/E Since 1990



Source: Fundstrat, Bloomberg

"Other income" is our best-performing asset class so far this year. This is a class of carefully selected investments that pay more income than ordinary bonds while offering the added advantage of growth as part of the total return.

We hope to see legislative progress soon on a growth agenda that can support the stock market at these levels. We are, however, cautious and prepared if gridlock should push back or further erode growth prospects for 2017 and 2018.

We believe that the small-cap domestic equities are still playing catch-up; they may even outperform the large-cap stocks if the rally holds. We use an exchange-traded fund (ETF) for this investment, because we consider this to be more an asset allocation decision than an individual stock decision.

We wish all of you a fun summer. We appreciate the trust you have placed in us and seek to honor that trust in the work we perform daily to manage your financial assets. Please feel free to send us your questions or comments. Your views are always welcome.

Elaine Longer

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