December 14, 2016

Re: <u>SFP Conference Call: Wednesday, January 4, 2017</u>

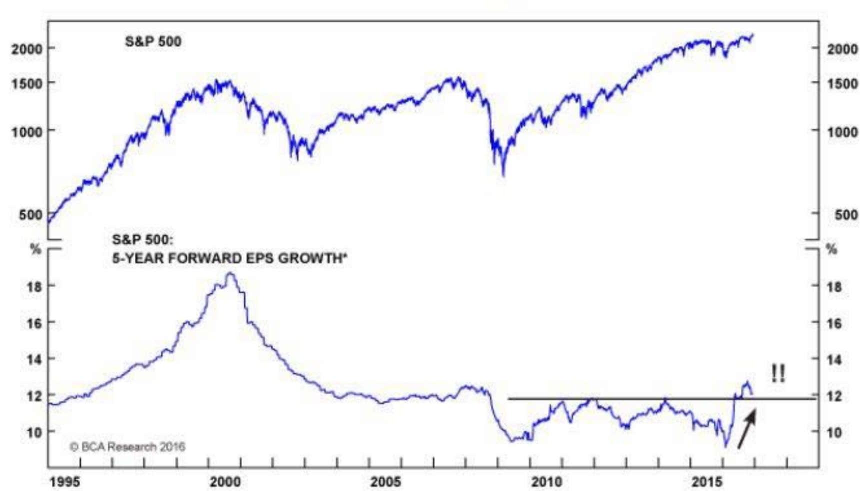
The stock market's performance since the election has been more than incredible. Honestly, it is mystifying. Most pundits, including BCA Research, believed that the U.S. stock market would go up by 4% if Hilary Clinton won and go down by 10% if Donald Trump won the election. We all know what happened.

At 10:00 p.m. on election night, it had looked like Hilary Clinton was losing. As I turned on my Bloomberg terminal at home, I gulped as I viewed the screen that glared a 900-point drop in the Dow Futures. I said to myself, "tomorrow is going to be a bad day" as my money manager job would turn into being a psychologist. However, by morning when the markets opened, the Dow was only off 282 points and by that afternoon's close, it was up 151 points. It has been going up ever since. The S&P 500 is up 6% since the election. What is most interesting is that the market has been essentially flat for the past two years, but started to rise after the election. Furthermore, the market is rising in face of an interest rate increase and a rising dollar. The economic fundamentals are improving, but not stupendously.

S&P 500 Essentially Flat For 2 Years Until the Election

Ironically, the stock market is signaling that better times are ahead. I will take this Trump rally but truthfully, it is based more on future optimism than reality. Don't get me wrong, I think optimism is good and it may just drive the economy, but the reality is that there has not been any major economic improvement. There are many good things that could happen that may lead to a further rise in the stock market, but there are also some negatives that could cause some short-term heartburn.

Sudden Optimism In The Long-Term Outlook!



One of those Rolaid moments deals with global trade. Investors are understating the risks that the Trump administration will enact protectionist trade policies. However, contrary to popular belief, the economic costs to the United States of a protracted trade war would be low. Keep in mind the U.S. is a relatively closed economy with exports only totaling 12% of GDP. The geopolitical impact would be much higher and the S&P 500 earnings would take a hit. This is the problem, not so much for the American economy, but the American stock market. Other countries, such as Mexico and China, trade would be hard hit. There is no doubt that infrastructure projects and tax cuts would be a boon to the economy and trickle down to the stock market.

Not too many investors are noticing the strengthening U.S. Dollar which has tightened monetary conditions and has led to higher bond yields. In the past, this has not been good for the stock market. Our guess is that on a three month horizon the market could correct by approximately 5% to 10% from current levels. No one knows this for certain and it is possible that it may not happen. However, if the market does correct then it will set up the stock market for positive returns down the road.

Stocks Tend To Suffer When Bond Yields Spike

GLOBAL BOND YIELD PRECEDING 3-MONTH SPIKE = 50 BPS	MSCI WORLD PRECEDING 3-MONTH RETURN	MSCI WORLD SUBSEQUENT 3-MONTH RETURN	DETERIORATION
JAN-2002	4%	-2%	-6%
AUG-2003	11%	2%	-9%
JUN-2004	2%	-1%	-3%
APR-2006	4%	-4%	-8%
JUN-2007	7%	-3%	-10%
JUN-2008	4%	-9%	-13%
JAN-2011	7%	3%	-4%
JUL-2013	4%	1%	-3%
NOV-2016	1%	?	?

NOTE: OCCASIONS WHERE THE 65-DAY CHANGE IN THE GLOBAL BOND YIELD (SMOOTHED OVER 5 DAYS) EXCEEDED 45 BPS.

At this juncture, we are reluctant to move to a substantially higher stock allocation because of an expensive market, high U.S. Dollar and political uncertainty in regards to trade. Add to the fact that higher interest rates could also sabotage the stock market rally, I have increased the equity allocations previously and I am comfortable where they sit now. I don't intend to go to an all stock allocation. Bonds serve a very important diversification purpose and they cushion any stock market downturn in the portfolios. An all stock portfolio is too risky.

US DOLLAR IS AT A TWO YEAR HIGH

In today's Financial Times, John Bogle the founder of Vanguard Funds wrote an excellent article on the problems of exchange-traded funds. I echo his sentiment. We have bought ETFs in the past and our success with them has been considerably less than our investing in individual stocks. In this article, Bogle discussed the trading mentality of many ETF owners that cause the S&P 500 index ETF to have a turnover of approximately 880% per year. That is a very high turnover! For long term investors who stick around, the in and out traders negatively affect their ETF's value. Furthermore, Bogle pointed out that the S&P 500 ETF trailed the S&P 500 index by 1.6% due to trading factors.

I don't like ETFs for several reasons. Investing in ETFs is like following the herd. When things are going good, ETF investors can do well, but when things go bad, they really go bad. For one, everyone in an ETF owns the same underlying stocks. Those stocks rise in value because everybody is buying the same thing - then they become overvalued. However, when a correction arrives, as they eventually do, many investors bail out and the ETF reverses direction. As you can see in the next chart, many ETF investors bailed out in 2008 and in 2015 when a large correction had occurred. Those who held individual stocks, in many cases held on, did much better and preserved their value.

In 2008 and 2015, many investors got trampled. Another reason I don't use ETFs, except for investments in foreign countries in which I need to hedge the currency, is because of efficient markets. The many eyeballs looking at a popular stock or ETF means that the stock or ETF is efficient. In efficient markets, it is very hard to make outsize returns. I am of the opinion that stock selection of inefficiently priced stocks produces the best returns.

Please join us for our next conference call on **Wednesday, January 4, 2017 at 6:30 p.m.** when Doc Martin comes from Cornwall to our office in Newport Beach to interview me about my views of the markets, economy and global economic environment. To access the conference call, **please dial the toll-free number: 1-800-914-8405. Once prompted, enter the access code: 5486434, followed by the # button.**

On behalf of all the hard working staff here at SFP, I would like to thank you for all of your confidence in us and we wish you a happy holiday season.

Sincerely,

Steven L. Yamshon
Investment Counsel