July, 2017

PENNIALL PERSPECTIVE

"We constantly challenge our ideas, assumptions, and process. We continually review the relevancy of data that shapes our outlook, the drivers of our decisions, and the biases that color our worldview. It is this ongoing self-evaluation that allows us to stay rooted in time-tested truths as we adapt to the ever-changing world around us."

-Penniall Investment Philosophy

Economic & Market Summary

The US equity market had positive returns for the quarter but underperformed both non-US developed and emerging markets. Smaller cap stocks generally underperformed larger cap stocks. Internationally, equities were also positive throughout both developed and emerging markets, with the majority of positive return coming from currency fluctuations rather than share price appreciation.

In the US bond market, performance was mixed during the second quarter as shorter term interest rates increased (bond prices fell) and intermediate and longer term interest rates decreased (bond prices rose). Here are some of the details:

- 3 month Treasury bill interest rate increased 27 bps to 1.03%
- 1 year Treasury bill interest rate increased 21 bps to 1.24%
- 10 year Treasury bill interest rate decreased 9 bps to 2.31%
- 30 year Treasury bill interest rate decreased 18 bps to 2.84%
- Short-term corporate bond interest rate increased to 0.59%
- Intermediate corporate bond interest rate increased to 1.49%

The US Federal Reserve took another step towards normalizing monetary policy by increasing the federal funds rate by another 0.25% in June.

Global GDP growth increased during the second quarter, most notably throughout Europe. In the US, unemployment fell to its lowest level in 16 years, while wages increased a meager 2.5%. US core consumer price index (CPI) inflation failed to meet expectations throughout the quarter, falling to 1.6% in June.

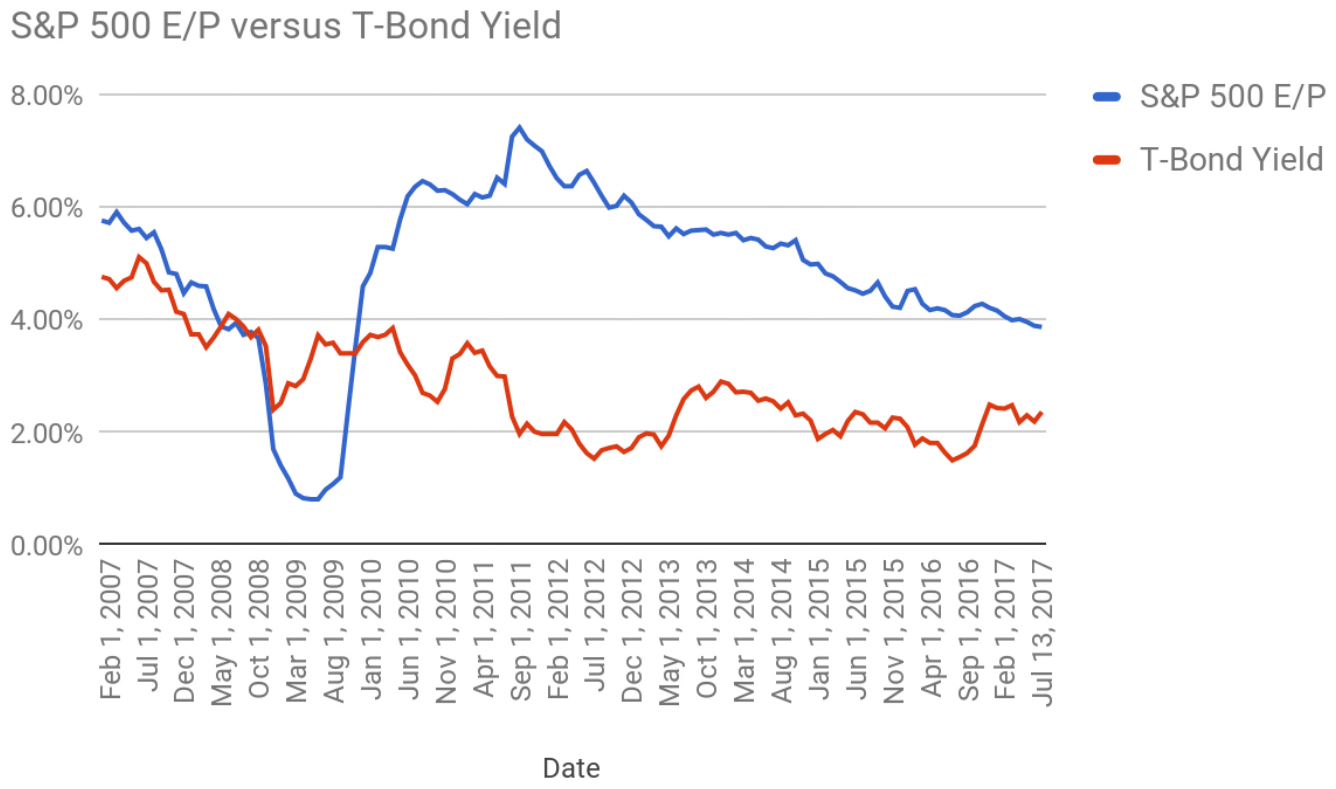
Bull Case

Despite being one of the slowest expansions on record, the US economy continues to prove its resilience and the global economy is strengthening. Recent data continue to suggest this persistent, albeit modest, growth trend may continue.

- Corporate earnings per share is estimated to grow at 8% for Q2 and 11% for the entire year before moderating in 2018 and beyond
- Industrial production posted its strongest quarterly rise in 3 years
- Higher than expected US job growth in June added 220,000 new jobs to the economy
- IMF predicts global output to grow at 3.5% for 2017 and 3.6% for 2018
- Fading populist political risk

The combination of slow growth and low inflation has been dubbed a “Goldilocks scenario” for markets and should continue to buoy prices.

Structurally, lower bond yields in our current environment create a need to modify traditional valuation metrics, many of which are “high” by traditional standards. As an example, the earnings yield of US stocks (earnings per share divided by the share price) is currently trading at an all-time high relative to its historical average, which suggests that stock prices are too high and are poised to fall. However, the earnings yield of stocks should not be analyzed in isolation. When comparing to bond yields, the attractiveness of stocks versus bonds is much more reasonable, suggesting stocks are actually undervalued and will continue to appreciate (see chart).

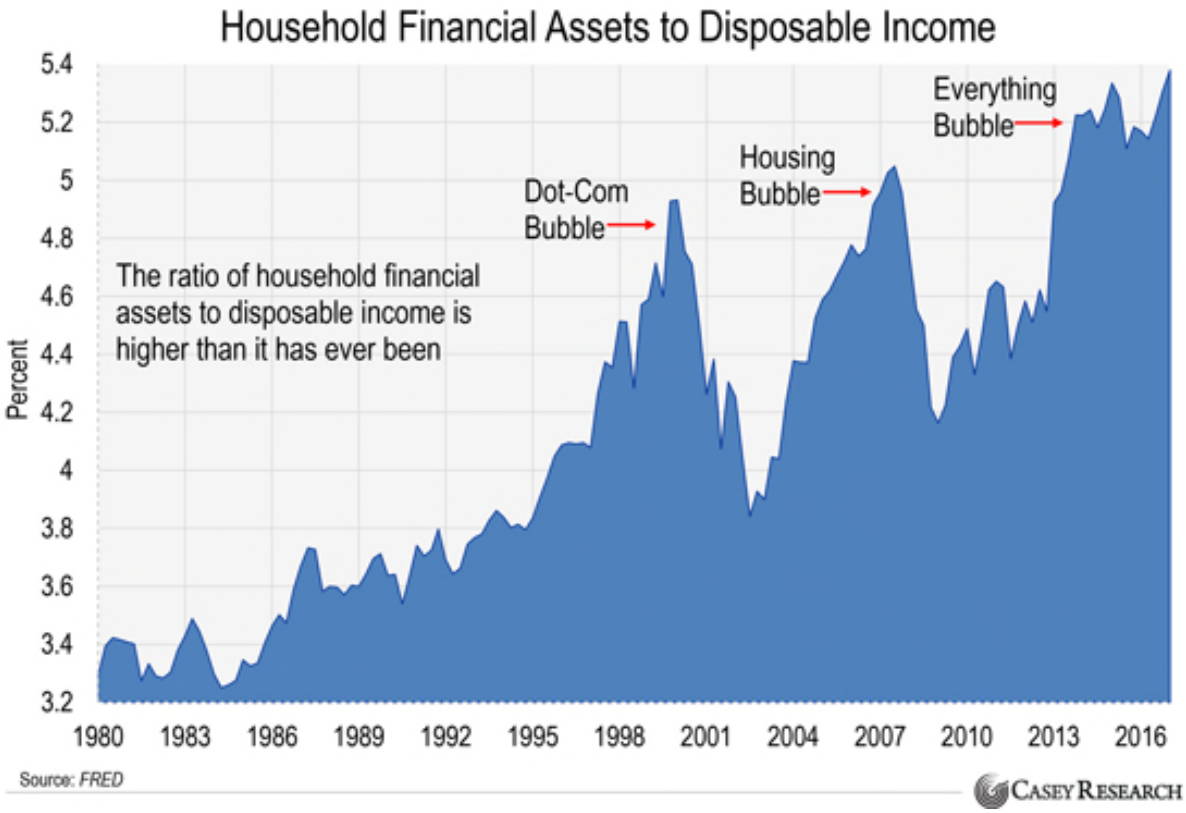


Source: Seaking Alpha

Finally, current price momentum in stocks is notably strong, an indicator that has historically fared well for markets.

Bear Case

Economic and market conditions are showing signs typical of late stage bull markets. Slowing nominal GDP growth, excessive stock market valuations, muted revenue growth, excessive corporate debt, high house prices relative to income growth, high auto debt levels, high commercial real estate prices and high household financial assets relative to disposable income (see chart) all suggest this bull market may be nearing its end.



Investor complacency seems to be more and more persistent even in the midst of elections and terror attacks, another symptom of aging bull markets. Additionally, we are fully in a tightening cycle as the US Fed continues its quest to normalize interest rates, which is a headwind to economic growth. Core consumer price index (CPI) inflation was essentially flat throughout the quarter, the worst growth rate since the Financial Crisis and the worst expectation miss since 1997.

US stocks are very expensive. The Shiller P/E ratio for the S&P 500, a valuation metric adjusted for inflation and using 10 years of earnings data to smooth results, is over 30x, which is the highest level ever outside of 1929 and the Tech Bubble. Historically, when stocks are expensive, the expected return for stocks over the coming years is significantly below its long-term average.

Conclusion

While we see potential for continued economic growth and higher stock prices, we are aware of the significant risks given the current environment. It is important to stay focused on your long term investment plan and avoid chasing markets. We appreciate your continued trust and partnership in helping you meet your long term financial goals.

PENNIALL & ASSOCIATES, INC.