StoneRidge Wealth Management
MAY 2017

The Quarterly Profit

POLITICAL YOGA

Let's all assume the Washington D.C. Cherry Blossom position. Whether your yoga mat is Red, Blue, or a shade somewhere in between, stand with your shoulders somewhat hunched, arms slightly outward, palms up and raised to shoulder height. That's right! Now contort your face, take a shallow breath, and give your most pained expression. Perfect! Now in unison, "What the heck is going on?" How did we get to this point, and how will the political riptides affect our investments? Health care, tax revisions, Mr. Trump, White House intrigue, he said she said, demonstrations, North Korea, immigration, Russia and the FBI...! **No political statements, please, and no sides taken!** I've been trying to write this column for the last few weeks, but just as elements of consistency began to emerge from the chaos of politics, economies, and markets, they quickly disappeared with the latest news bulletin or early morning tweet. However, it appears that the markets are now beginning to shrug off the political dysfunction and return to the fundamental criteria of the U.S. and global economies. If we think of the economy as a very large and powerful river that charts its own course and cuts its own banks, we realize that our presidents have had relatively little power over it. (Wasn't it Xerxes, a Persian king in ancient times, who had his soldiers whip a river for sinking his boats?) The good news is that the U.S. and global economies seem to be strengthening, and that our portfolios have a very good chance of continued positive trending despite the dysfunction in Washington. The bad news is that any meaningful legislation, whether proposed by Democrats or Republicans, will probably be severely challenged in this poisoned political environment.

The Dow hit the 20,000 mark this year (Jan. 27) for the first time ever, then regrouped and broke 21,000 on March 1. The talking heads piled on, with predictions ranging from the big crash (Harry Dent called for his usual 60% plunge) to the Dow at 30,000! For a reality check, you might recall my Quarterly Profit (3d quarter, 2014) where I suggested the Dow would probably break 20,000 by the fall of this year. (It doesn't take a statistical genius to compound a 7% annual market gain during a strengthening economy) Remember, the markets are always rising except when they're not, and there is no compelling reason to suggest the markets are significantly overvalued. Sometimes a flood and sometimes a drought, but the high-water mark will continue to inch upward, especially in a period like this when most indicators point to a strengthening economy. (continue...)

Political Yoga (continued)

It's been more than seven months since the elections, and much has been made of the "Trump Bump", and the positive impact that Mr. Trump's election may have had upon the markets. The Dow has gained more than 13% since the elections, (through May 19) as bank stocks led the charge in the early stages with the expectations of a relaxed regulatory environment and tax reductions. However, the markets had shown almost no gain at all in the previous eighteen months and had already begun a solid recovery in the week before the elections. Therefore, some percentage of the post-election rally may be attributed to the markets simply "catching-up" after a very challenging two-year period, as well as the increasingly positive data regarding growth in the global markets.

The most important question is whether or not the markets will remain positive as Mr. Trump confronts the political turmoil in Washington, including the FBI's investigations into possible campaign collusion with Russia. The greater the percentage of the post-election market increase attributed to economic forces, the less the markets might retreat as Mr. Trump encounters forceful headwinds. I believe the events of May 17 are especially telling, and offer a window to the relationships of our political drama and the markets. The Dow plunged 373 points after a special prosecutor was appointed, but then recovered most of the loss within the next three trading days. My personal opinion is that the markets will suffer relatively little negative impact from the ongoing political chaos, and will continue to respond positively to the strengthening of the US and global economies.

I'd like to borrow liberally from a recent issue of the Economist, (March 18, 2017), that states "It looks likely that this year, for the first time since 2010, rich-world and developing economies will put on synchronized growth spurts". The article also quotes Mario Draghi, President of the European Central Bank, saying that the risk of deflation has largely disappeared, bolstering the probability of positive economic trending in Europe, despite the challenges of Brexit. And from The Wall Street Journal (May 17, 2017) documenting our own industrial output, "...the unemployment rate falling to its lowest level since 2007; solid consumer spending gains at online sellers, restaurants and other retailers, and existing home sales climbing at their fastest pace in a decade." With my own warnings that nothing is ever certain and that positive trending can quickly stall and reverse, I believe that we should be encouraged by these positive reports, and look forward to positive market trending throughout 2017 and into 2018. Whether our yoga mats are red or blue, we might find this data soothing as we try to reduce our political angst.

Should we be concerned that the Dow is hovering around its all-time high of 21,000? Many of the talking heads are claiming that the markets are dangerously overvalued, and that a serious correction is imminent. But on what basis? Remember the old statistics joke? "In God we trust, but everyone else must come with valid data!" We all know that anything is possible, and that the markets can unexpectedly head south, but the data seems to support the reasonable expectation that our markets will continue to trend positively. But if the markets aren't overvalued, how do we explain Professor Robert Schiller's CAPE index (Cyclically Adjusted Price Earnings ratio) that suggests our stock valuations are, in fact, dangerously high? Much is made of the CAPE, which averages the Price Earnings Ratios (stock price per share divided by the earnings per share) adjusted for inflation, over the preceding ten years. The higher the ratio is, the greater the possibility that the markets are overvalued, and the greater the chance of potential market correction and portfolio loss. As an example, a stock trading for $100 per share, with earnings of about $6.00 per share, would have a PE ratio of about 16.7. ($100/$6) Historically, the S&P's PE ratio has averaged from 16 to 18, but the CAPE is now about 29.

But here's the catch! In most rolling ten-year cycles, the CAPE Ratio will certainly offer valid insights as to comparative market valuations. Exceptionally high share prices relative to average earnings will justifiably suggest an overvalued market. Conversely, exceptionally low earnings relative to average share prices will also distort the same ratio, giving the appearance of an overvalued market when in fact, that simply may not be the case. The last rolling ten year period includes the great debacle of 2008, which was a perfect storm and hopefully, a once in a century event. For several quarters in 2008 and 2009, the markets registered almost no earnings at all. This extraordinary event sent the PE ratios sky high, seriously distorting the CAPE averages, and erroneously indicating an overvalued market today. In our $100 per share example above, had the stock dropped in value to $70 in 2008, and if corporate earnings were only $1.00, the PE Ratio would have jumped from 16.7 to 70! To further distort today's CAPE and give the appearance of an overvalued market, corporate earnings in 2015 and 2016 were exceptionally low, and did not begin to show significant gains until the 3d quarter of 2016. And what does the earnings data indicate for 2017? I believe that we should be encouraged, as the first quarter showed the greatest corporate earnings growth in six years. Remember, continued growth in corporate earnings usually justifies a reasonable increase in market value, and supports the expectation of positive markets.

At the risk of being overly optimistic, let's give the Market Growth yoga position a try now. Blue and Red mats together, arms hanging easily at our sides, shoulders relaxed, calm demeanor. In unison, "the economy drives the politics, the data is increasingly positive, protection first, growth second."

Van Mason, CFP®, CLU, MBA

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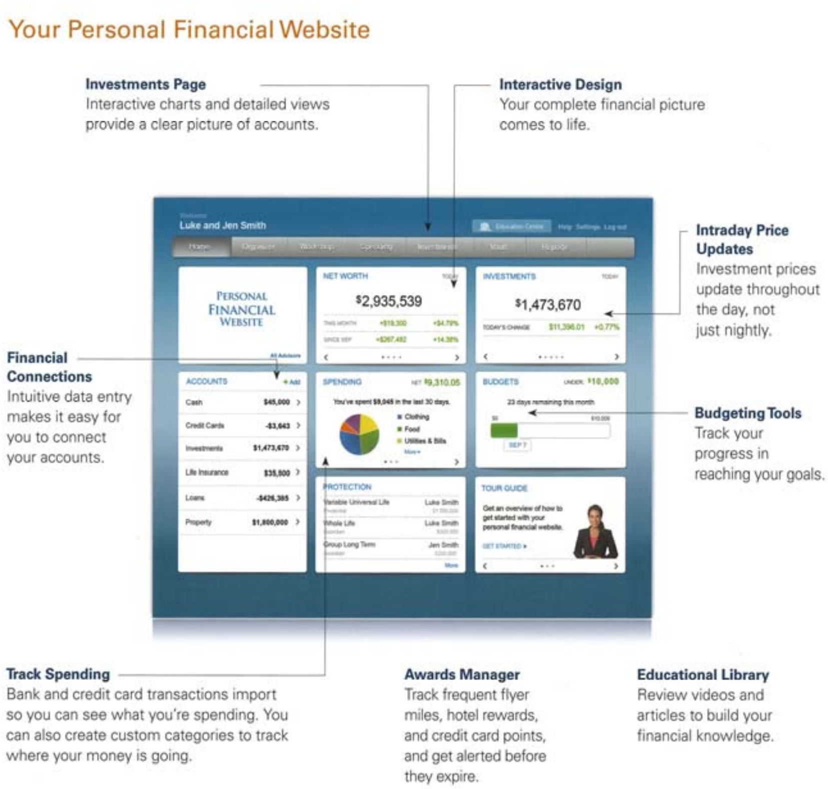

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