

To: Aequitas Client

From: Aequitas Investment Advisors

**Subject: Rational or Irrational Exuberance?**

Dear Client,

The year 2017 will probably be remembered as one of the more *surprisingly* positive years for the stock market, especially given the political gyrations in Washington and troubling developments on the geopolitical front. Investors apparently ignored the uncertainties and, instead, focused on an improving economic picture in the US and around the globe, as well the anticipated additional stimulus of lower tax rates for corporations and individuals. For the year, the MSCI All Country World Stock Index surged by 24% with the greatest gains coming from stocks outside of the US. With the stock market now in record high territory propelled by seemingly blind investor optimism, some pundits are suggesting we're entering another period of *irrational exuberance*, a phrase used by former Fed Chairman Alan Greenspan to describe the extremely overvalued stock market of the dot-com stock bubble in the late 1990s. While it does appear that stock prices in the US may be overvalued and due for a correction, investor exuberance in 2018 may arguably be rational given the positive economic outlook in the US and abroad.

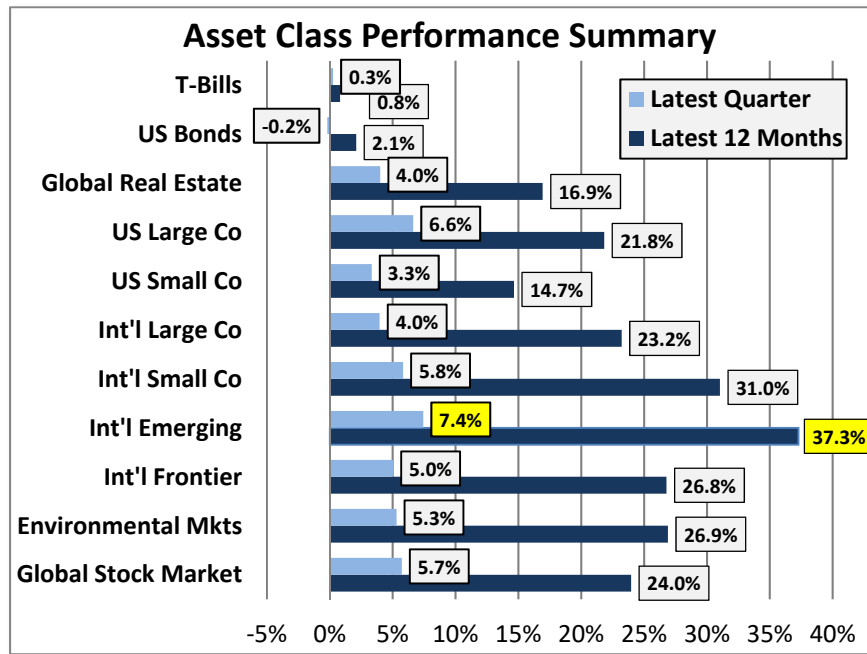
As measured by manufacturing output and employment growth, the global economy is accelerating at its fastest clip in close to a decade with the strongest activity coming from Europe (despite ongoing Brexit negotiations). Consumer confidence, another indicator of economic health, has risen to the highest level since 2007. Businesses are more confident as well, especially small businesses in the US which are critical drivers behind employment growth. In the graph at the top right of the page, note the sharp uptick in corporate earnings around the globe which began in early 2016. While earnings in the US had been climbing rather steadily since 2012 (after a sharp rebound between 2009 and 2012), corporate earnings in other regions have only more recently picked up steam. The rate of unemployment has fallen to the lowest level in more than 15 years and we may (finally) see meaningful wage gains for workers in 2018. In a recent interview with the *Financial Times*, Chief Economist Jan Hatzius at Goldman

Sachs reported the investment bank's forecast of 3% wage growth in the US with the unemployment rate falling to 3.5% (which would be the lowest level in more than 50 years!). Goldman's forecast for GDP Growth in the US is between 3% and 3.5%, with an even higher growth forecast of 4.1% for the global economy. Of course, should such forecasts materialize, we might also anticipate rising inflation and higher interest rates. There are significant risks to the optimistic forecasts, of course, including political and geopolitical risks and the possibility the Federal Reserve, as well as other central banks, might stifle growth by raising short-term interest rates too quickly. Nonetheless, there is broad consensus from economists that the global economy is in a synchronized expansion which should further strengthen corporate earnings and provide firmer support for stock prices. This doesn't mean we should expect another year of 20% gains from stocks; rather, it's more likely we'll see modest gains with the strong possibility of a price correction given that stock prices have gotten ahead of fair value, especially in the US. Professor Jeremy Siegel of the Wharton School, who correctly predicted a year ago that the Dow would reach 24,000 in 2017, sees US stocks taking a "breather" in 2018 with a return of between 0% and 10%, but he also foresees a 10% correction at some point during the year. We concur with Siegel's forecast and, assuming the global economy remains on a positive trajectory, would view a correction as an overdue rebalancing opportunity rather than a sign of an impending recession.



## Asset Class Performance Review

Over the last twelve months, stocks around the globe gained 24% which is more than double their long-term historic average and about three times their expected return over the next ten years! Within the stock asset classes, last year's winner, US Small Co's, was this year's loser with a gain of 14.7% (not bad for last place). Leading the pack were Emerging Markets Stocks with a gain of 37.3%. The range of returns from the other stock asset classes was between 16.9% (Global Real Estate) and 31.0% (International Small Co's). For the year, foreign stocks outperformed US stocks; perhaps marking a turning point given the outperformance



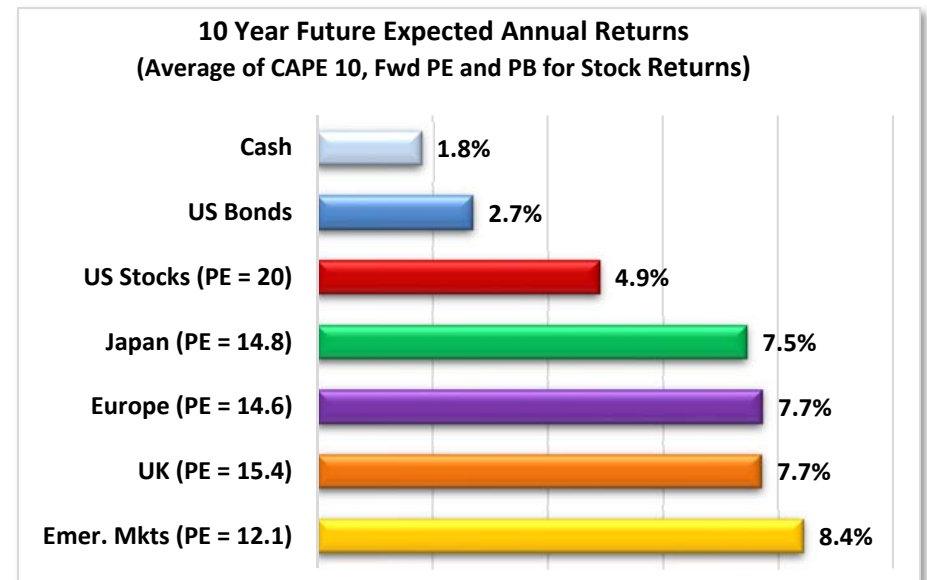
of US stocks over the past five years. US Bonds finally showed some life with a return of 2.1% (keeping pace with inflation) and T-Bills eked out a small gain of 0.8% (T-Bill rates are now at 1.4% following many years of near zero rates).

For the latest quarter, the returns were positive across the board with the exception of US Bonds (-0.2%); a reflection of the fact that interest rates are rising (rising rates cause a temporary loss of market value for bonds). T-Bills were up by 0.3% for the quarter. Within the stock asset classes, returns ranged between 3.3% for US Small Co's and 7.4% for the Emerging Markets. Globally, stocks gained 5.7% as measured by the MSCI All Country World Index.

### Stock Market Valuations and Future Expected Returns (Update)

In our last quarterly letter, we reviewed various valuation measures which provide clues about the rates of return we might expect in the future. We utilize three methodologies which have historically offered meaningful information about future stock market returns: (1) the Shiller Cyclically Adjusted Price-to-Earnings Ratio based upon corporate earnings over the past 10-years (CAPE 10); (2) the Price-to-Earnings Ratio based upon analysts' estimates of corporate earnings over the next twelve months (Forward P/E) and the Price-to-Book valuation method (i.e., the share price of a stock divided by the company's book value per share). As we would expect, given the run-up in stock prices over the past three months since our last update, the expected rates of return for all the stock asset classes have fallen. On the other hand, the expected returns for cash and US Bonds has risen slightly given the rising interest rate environment. We've compiled the average expected returns of the three methods in the chart below and have also included return estimates for Cash and US Bonds. Note in the parentheses next to each label of the stock market regions we have indicated their current Forward P/E Ratios with a lower number suggesting potentially higher future returns. Clearly, with a P/E Ratio of 20, US stocks are expensive relative to other major regions which have P/E Ratios of between 12.1 and 15.4.

Current expectations suggest that US Bonds will provide a relatively low return of 2.7% over the next decade versus their historic average of 4% to 5% (inflation



is expected to remain in the 2% to 2.5% range). Non-US stocks are expected to outperform US stocks between 2.5% and 3.5% annually over the next ten years, with stocks in the Emerging Markets offering the highest expected returns. As we have mentioned previously, these return figures represent long-term expectations which we use for planning purposes and are *not* intended to be predictors of short-term movements in stock prices.

### **Portfolio Considerations for 2018**

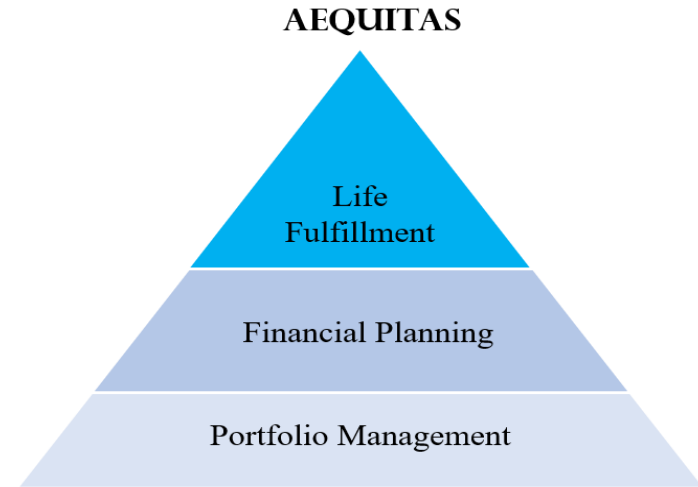
We've made some adjustments to our recommended model portfolio which have been recently or will be integrated into client portfolios in upcoming reviews. Below are some of the recent adjustments and a few we plan to introduce later this year:

1. With expectations for higher inflation and rising interest rates, last year we added a short-term inflation protected securities fund to the Fixed Assets allocation and we will maintain our short-term bond duration for 2018.
2. Given the significant difference between expected returns for US stocks versus non-US stocks, in the latter half of 2017 we raised our target for non-US stocks from 42.5% to 45% of total stock exposure. Pending further evaluation by our investment committee, we may recommend a further increase in the non-US target in future rebalancing opportunities.
3. We are continually looking for ways to lower the average expense ratio of our recommended mutual funds and have identified several areas where we have and will continue to make progress. We are finalizing our research and expect to introduce one or two fund replacements in 2018.

### **New Year's Resolutions and Our Role as Fiduciaries**

From Tim Nash, Principal and Chief Portfolio Strategist

As we start a new year, many of us might make commitments about such goals as more exercise, adopting a healthier lifestyle, travel plans, living within our budgets, or reconnecting with old friends. At Aequitas, we've also made a commitment to emphasize our role as fiduciaries and are looking at ways to serve our clients in a more impactful manner. Since 1991, the mission of Aequitas has been to provide our clients with highly personal financial planning and efficient portfolio management services. We have come to know most of our clients quite well and have pursued ways to expand our services to meet their evolving needs and goals.



### **Fiduciary Support Throughout Your Financial Life**

The renowned American psychologist, Abraham Maslow, stated that people are motivated to achieve certain needs, and that some needs take precedence over others. At the most basic level, people have needs for food, water, security and safety. At a higher level, people have needs for belongingness and love, prestige and feelings of accomplishment. And at the highest level, people have the need for self-fulfillment, or achieving one's full potential.

Here at Aequitas, we have found similar parallels with the services we offer our clients. At the most basic level, we provide cost-efficient portfolio management services for assets that have been earned, inherited, saved and grown over the years. At a higher level, we provide financial planning services which address how one's financial resources might be utilized to achieve specific and quantifiable goals while mitigating potential financial risks. Ultimately though, our objective is to have each of our clients achieve a level of self-fulfillment that includes their greatest aspirations. Perhaps a new vocation, the ability to fulfill lifetime travel goals, creating a family legacy, or serving one's charitable interests. We welcome the opportunity to further explore your hopes and dreams, as we continue to help build and illuminate the path to help you reach them.

We look forward to our work together in 2018 and beyond!

