Fake or Real?

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In what has been described as the least fun bull market in history, the market is taking a pause as we ricochet from one new Washington policy proposal to the next. I'm constantly asked how long it will last and whether the rally is for real? While I will distance myself from the third rail of political commentary I have no problem with watching account values increase. That's as real as it gets! It also appears that the Fed is finally beginning to move in a more deliberate fashion towards a higher interest rate policy. The most recent rate increase which happened on March 15th was met with positive market response, up 112 points on the Dow. Maybe the fears of Fed tightening were unfounded, or maybe it's the fact that Wall Street has been predicting these increases for the past four years in what we refer to as "*the worst kept secret on Wall Street*". The bottom line is that the economy is improving, business optimism is high and interest rate increases are the response. So good news is bad news is good news… go figure!

Wells Fargo Investment Institute (WFII) has recently published a report stating that they feel that the bulk of the gains for the entire year of 2017 may have already been realized*. This is not to say that it's time to sell, selling comes at a cost both in terms of transactional cost and capital gain realization. My point is that we may take a pause and that volatility may replace upward trajectory in the near term. At 17x forward estimates US market valuations (S&P 500) are not cheap in our view, but they are not dramatically overvalued either. Typically stocks go up for two reasons; their earnings increase or the price-to-earnings multiple expands. We believe that the P/E multiple expansion phase may have run its course and that any continued run up in stock prices would be earnings driven. WFII has projected earnings to be up 9+% from 2016 estimates and the forward outlook continues to be positive. So far so good. We are also beginning to see increasing interest in the developed international markets after several years of underperformance. In aggregate, developed international markets like the EU are behind us on the economic recovery curve but in our opinion offer better valuations. Over the past 40 years, from 1970-2009 the EAFE (**E**urope **a**nd **F**ar **E**ast) has produced an average annual return of 9.33% versus the S&P 500 of 9.85%. It's only been since 2010 that the performance differential has been significant with an average annual underperformance of 8.47% per year for the EAFE. My point is don't get lulled into thinking that it's always been this way or will always continue to be this way as we move forward. The Wells Fargo Investment Institute (WFII) has recently increased their target objectives for both developed international markets as well as emerging markets.

As equity markets continue to move higher and bond valuations lower, rebalancing should be considered. Fixed income is vulnerable in a rising interest rate environment and it's easy to make the case that investors will sell poorly performing assets (bonds) and move them to equities as interest rates move higher. At the same time, as rates increase, bonds yields become more attractive and will ultimately draw money back into the bond market. So what's the best course of action? Keep your bond maturities short to medium-term to reduce principal risk and be prepared to extend maturities as interest rates start to ratchet higher. I expect this may unfold over the course of several years but ultimately, in this recovery cycle, higher interest rates are a sign of an improved economy and will ultimately help bond investors with higher cash flow. It's about time the Fed positioned itself for growth instead of stimulus.

*WFII Global equity Strategy report published 3/15/2017. Available upon request.

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