Market Update

February 3, 2017

The Dow Jones Industrial Average (DJIA), which debuted in 1896, marked a historic high when it closed above the 20,000 level for the first time ever this past week. For reference the DJIA first reached 100 in 1906, hit the 1,000 level in 1972 and hit the 10,000 level in 1999. After weeks of coming very close to the milestone level, the 30 member index finally broke through and hit 20,000.

On January 20th Donald Trump was sworn in as America's 45th President. His inaugural address largely echoed the populist rhetoric of his campaign. Trump repeatedly stressed that his election represented a transfer of power from the hands of politicians back to the people. He said that America's interests would remain primary in every decision going forward. Trump encouraged Americans to "think big and dream even bigger" and promised to work for the success of all citizens. He came back to the theme of rebuilding infrastructure several times, and said he would work to protect our borders from the economic ravages of other countries.

Much of the stock market's rally since the presidential election seems to be the result of optimism about the president's new policies and the potential for a period of above trend economic growth. For example business, consumer and investor confidence have all risen in response to what looks like it should be a more business-friendly environment under President Trump.

To be clear the market's recent advance is not 100% due to excitement about Trump's policies. Economic data has been improving for several months now, providing encouragement that the economy appears headed in a more positive direction. Recent data has mostly confirmed that the economy has picked up some momentum.

Looking at corporate profits, after five straight quarters of negative year over year earnings per share (EPS) growth, EPS growth turned positive during the third quarter of 2016, is currently forecast to generate positive year over year growth for the fourth quarter of 2016 and double digit growth in both 2017 and 2018 (source: Factset). Over time, we believe that stock prices tend to follow the direction of company earnings, so this is an important trend to keep an eye on.

We are now in one of the longest bull markets and economic expansions on record. However, the length of the expansion, in our opinion, is not reason enough for concern. Historically the first year of a new president has provided positive returns for investors. Overall the average full year market advance in year one of a president's four year term is 5.2% (source: Investech). Despite the likelihood of a pullback or correction during the first half of 2017, we believe that further gains (i.e. new bull market highs) are likely in the months ahead before the next recession hits at some point in the future.

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Debt and Deficits

One concern we have is rising debt levels and what impact President Trump's pro-growth plans may have on our nation's already high deficit levels. According to the Congressional Budget Office (CBO), the budget deficit is forecast to rise from 3.2% of GDP in 2016 to 5.0% in 2017 and 6.1% in 2018. Separately, according to the Tax Policy Center, Trump's tax plan would add about $6 trillion to federal debt over the next 10 years and more than $20 trillion over the next 20 years. Even if robust growth assumptions are applied, the math around rising deficits/debt may start to get fairly negative and weigh on the economy before too long.

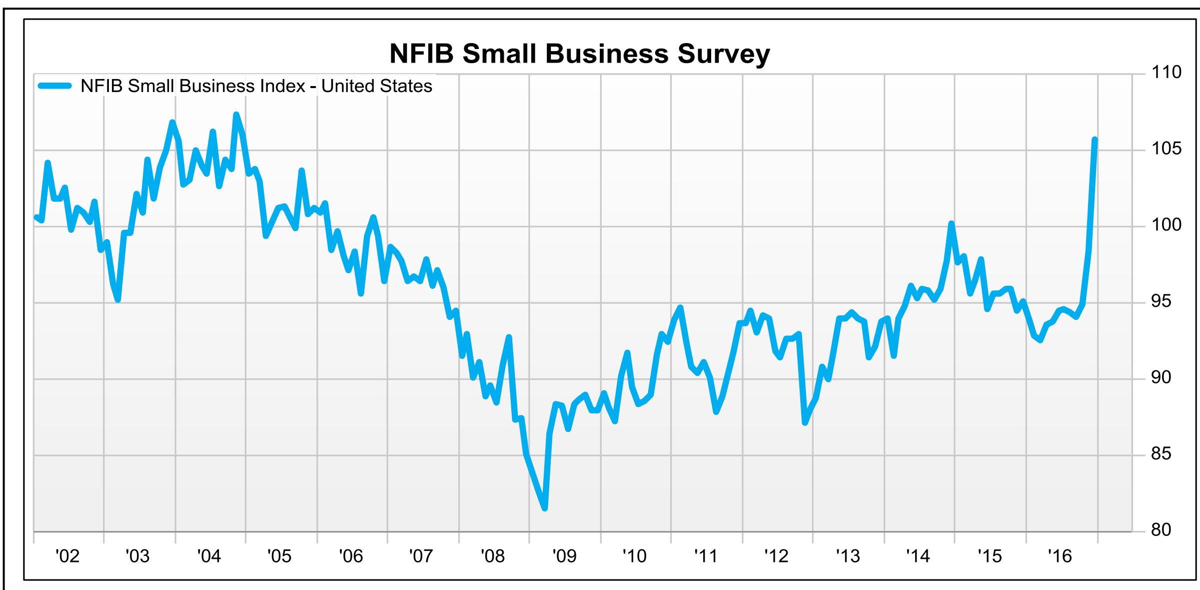
When will The Growth Hit?

The big issue in everyone's mind is which of President Trump's various campaign pledges will actually turn into law and ultimately impact the economy? President Trump is focusing on several big issues including lower corporate and individual taxes, decreased regulation, increased infrastructure spending and repatriation of corporate cash held overseas. The decision to allow the Keystone Pipeline this past week shows that President Trump is serious about following through on some of his campaign pledges and boosting growth. We believe that some of his plans are likely to get passed in the months ahead and have a positive impact on growth. However, timing is uncertain as are the potential for unintended consequences such as trade wars and rising deficits.

Tax legislation can be complicated and some Republicans may not approve of increased infrastructure spending if it leads to larger budget deficits. Thus there is the possibility that growth comes in below expectations during the first half of the year before accelerating later this year into 2018 as legislation eventually gets passed and creates a positive tailwind for the economy.

Confidence Levels on the Rise

One encouraging sign that we have seen recently is that consumer, CEO and small business confidence levels have all experienced significant improvement over the past couple of months. We believe this reflects increased optimism that the economic, tax and regulatory outlook may improve. For example, last month the Conference Board's CEO survey posted its largest one month increase since 2009, the NFIB Small Business Survey posted a record 7.4 point increase (see chart below– source: Factset) and the University of Michigan's Consumer Sentiment Index rose to a 15 year high.



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Corporate Profits

Over time we believe that stocks tend to follow the direction of corporate profits. On that front, we are encouraged that after several quarters of negative year over year profit growth, corporate profits turned higher last quarter. Looking ahead, corporate profits for the S&P 500 are currently forecast to rise from $118.12 per share in 2016 to $132.32 per share (up 12%) in 2017 and to $147.80 per share (up 12%) in 2018. We are wary of having too much confidence regarding the outlook for corporate profits looking out more than a few quarters. However, if profits were to continue to trend higher over the next year or two, we believe that this would represent a positive tailwind for equity markets.

The Consumer

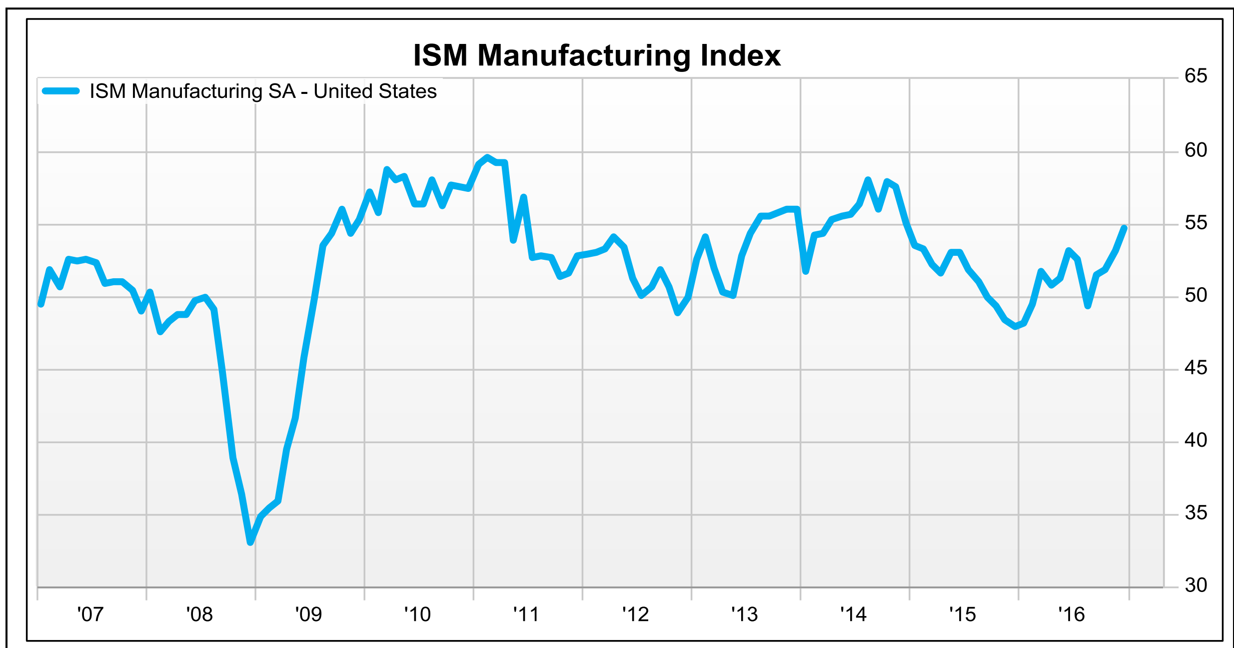
Consumer spending represents about two thirds of the economy and is thus important to keep an eye on. With employment continuing to grow, weekly jobless claims at historically low levels, household net worth at record levels, wages finally starting to rise and consumer confidence improving, we believe the outlook for the U.S. consumer appears relatively positive to start 2017. According to BCA Research, spending on consumer essentials (i.e. energy, healthcare, food and financial obligations) currently stands at a multi-year low of 41%, which should help provide consumers with fuel to increase spending on discretionary items.

Manufacturing

The Achilles heel of the economic expansion so far has been weak business and equipment spending. From 2015 into 2016, a combination of a strong dollar, falling energy prices and weak growth overseas led to a period of especially weak growth in the manufacturing sector. We are encouraged that more recently, some of these trends have started to turn around. For reference, the widely watched monthly ISM Manufacturing Index has now been above the key 50 level (indicating expansion) for four straight months (see chart below – Source: Factset).

Market Valuation Levels

We have commented in the past that market valuation levels have been on the high side recently. Currently the forward 12 month P/E level for the S&P 500 is around 17x versus a 15 year average of 15.5x (source: Factset). There are a range of different



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valuation levels that we monitor including the Shiller P/E, Market Capitalization to GDP, the market's equity risk premium (which compares interest rates to the earnings yield of stocks) etc… The bottom line is that most market valuation levels remain on the high side historically. However, given historically low interest rates, improving economic data and rising earnings, we believe that an above average P/E level by itself is not enough of a reason to become overly negative.

THE FED

According to Federal Reserve Chair Janet Yellen, the decision to raise the Federal Funds target (i.e. the short term Fed Funds rate) this past December for the second time this cycle was "a reflection of the confidence we have in the progress the economy has made and our judgment that progress will continue." Historically the Federal Reserve Bank has produced a poor track record when it comes to raising rates. In past cycles during the post WWII period, when the central bank starts raising rates, it has more often than not, led to economic downturns.

This time around The Federal Reserve Bank has indicated that they will likely raise rates three times in 2017 as they continue to normalize short term rates. Throughout the current economic recovery, Fed officials have consistently over-estimated economic growth. Therefore, we believe that short term rates are likely to trend higher but at a gradual rate. This should help sustain the economic recovery over the next several quarters.

MARKET PULLBACKS AND CORRECTIONS

Recent economic data trends have been positive and underlying market internals also remain supportive. However, that does not mean that we will not experience a market pullback or correction at some point. We have frequently tried to highlight that pullbacks and corrections are a normal and healthy part of investing. For reference, since 1928, market pullbacks of around 5% have occurred once per quarter, corrections of 10% or more have occurred approximately every 8 months and market declines of 20% or more have taken place once per market cycle or every 20 months (source: JP Morgan). Pullbacks and corrections help temper investor expectations and keep excessive optimism in check.

OVERSEAS

Over the past several years U.S. equity markets have outperformed foreign markets due to the fact the U.S. economy has exhibited stronger and more consistent growth. At RDM Financial we have appropriately over-weighted U.S. equity markets over the past several years reflecting these trends. After significantly underweighting foreign markets for several years, we are now in the process of putting our toe back in the water overseas. Yes Europe, China and other parts of the world still face issues (that will always be the case), but after several years of underperformance, we believe that the pendulum may be about to change somewhat with foreign markets performing better than they have over the past several years. For reference, the S&P 500 currently trades at about 17x forward 12 month earnings while the world outside the United States currently trades at a more attractive 14.1x forward 12 month earnings (source: Factset).

THE DOW HITS 20,000 – WHAT DOES IT MEAN?

As highlighted above, the DJIA hit 20,000 this past week for the first time in its more than 100 year history. What impact will that have on RDM Financial and how we go about investing client assets? Some may ask did I miss the rally, should I take money off the table, or should I get invested more now? At RDM Financial we have always focused on building financial plans, creating an appropriate asset allocation framework and staying disciplined in our investment approach. We believe it's all about helping clients meet their long term financial goals and cash flow needs. So no, we are not currently

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making major changes just because the DJIA hit 20,000. For now we are sticking to our investment process which means making changes in our portfolio over time based on fundamental changes in the economy that affect things like sales, profits, inflation, interest rates, valuation levels and corporate profits.

Fixed Income Markets

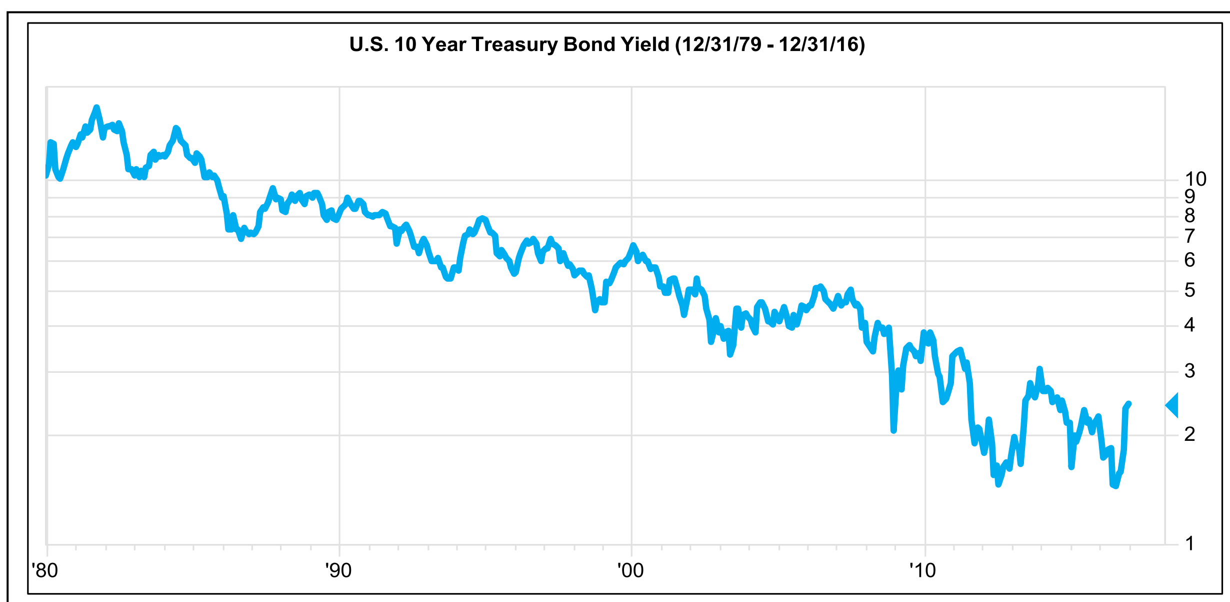
Since reaching an all-time low last summer, the yield on the U.S. 10 Year Treasury Bond has staged a significant turnaround with bond yields rising to a recent high of 2.60% in late 2016. We believe that the recent rise in yields is a function of several factors including better economic data here at home, expectation of additional rate hikes by the Federal Reserve Bank and somewhat higher inflation data.

Over the past few weeks yields have backed off their recent highs by a little bit. This is likely the result of investors looking ahead and evaluating both the positives and potential uncertainties for the economy and financial markets under President Trump. It is our feeling that the fixed income markets are likely in a multi-year transition period from falling rates (which started back in 1980) to rising rates (see chart below – source: Factset).

We believe interest rates are likely to rise further in 2017 reflecting mostly positive trends in the U.S. economy and policy normalization by The Federal Reserve Bank. Some analysts have commented that tightening labor markets along with rising inflation and wage pressures will put significant upward pressure on U.S. rates in 2017. While interest rates are likely to head higher over the next several years from current levels, we believe that the economy still has some additional slack both in the labor markets and manufacturing sector. In addition low rates in many countries overseas are also helping to keep our rates lower than they would be otherwise. Therefore, higher rates are likely, but a substantial jump up in rates this year appears less likely (at least not just yet).

Investment Themes – Dividend Growers

We wanted to highlight one investment theme that we have utilized across many of our investment portfolios at RDM Financial called “dividend growers”. It is a focus on managers that invest in companies that increase their dividends on a consistent basis over time. Historically (from 2/2/87 – 12/31/15) dividend growers have generated total returns of 13.4% per year compared with 9.4% for companies that kept their dividend rates unchanged,



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7.1% for companies that pay no dividends and 6.7% for companies that have cut their dividends (source: Ned Davis Research).

Dividend growers were also able to generate their returns with a lower volatility (i.e. standard deviation) of 14.5% compared with 16.9% for companies that kept their dividends unchanged, 24.4% for companies that do not pay a dividend and 22.3% for companies that cut their dividends. While dividend growers will not produce the best returns in every market environment, we think of them as core holdings and believe that they represent an attractive part of our investment portfolios.

Summary

Unlike 2016 when equity markets started off the year on shaky footing, economic data and market internals look mostly positive to start the year. We are keeping an eye on a variety of economic indicators including weekly jobless claims, credit spreads, the Leading Economic Index, housing starts, the money supply and consumer confidence levels. As we start 2017, a majority of these indicators remain positive.

President Trump has just begun to run the government. He has put forth a pro-growth agenda aimed at boosting employment, manufacturing activity and overall growth. This agenda has the potential to awaken "animal spirits" and help boost economic growth. As investors, a big question we ask ourselves is how much of President Trump's plans will actually make it into law and get enacted by Congress. This is an unknown that will only become clear in coming months. Until then, investors and the markets may face some policy uncertainty.

Looking ahead to 2017, at least for now, we remain moderately positive anticipating that rising confidence levels, an increase in corporate profits along with gradual rate increases by the Federal Reserve Bank and some pro-growth policy initiatives out of Washington should help generate additional upside for the economy and financial markets. We do anticipate that there will be a pullback or correction before too long but remind investors that this is to be expected and a normal part of investing.

Valuation levels are also historically on the high side and while this will not necessarily prevent the market from advancing higher, it may limit the market from advancing too far too fast. GDP growth last quarter came in below expectations at a rate of just 1.9%. This was certainly disappointing and compared with expectations of growth of 2.2% along with a more solid growth rate of 3.5% the prior quarter.

Importantly we don't see a recession ahead based on current market fundamentals. In fact, we believe that the economy may actually experience a pickup in growth if the president and Congress successfully implement some of the positive aspects (without the negatives) of the incoming administration's new plans. One thing we can't forecast at this time is whether the economy experiences a short term pickup that just lasts a few quarters or whether a longer term period of above-trend growth (something we haven't see in quite a while) returns.

Among the potential risks that we see, President Trump's pro-growth plans may get watered down or fail to live up to expectations, interest rates and the dollar could rise more sharply than expected, equity market valuation levels could rise more quickly than justified based on underlying fundamentals, or a geopolitical event overseas could adversely impact global financial markets.

Respectfully,

Ronald D. Weiner
Managing Director & Partner

Michael Sheldon
Executive Director, Chief Investment Officer

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