{PMFA} Special commentary

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March 28, 2017

JIM BAIRD
CPA, CFP®, CIMA®
Partner,
Chief Investment Officer

EDWARD RUMLER
CFA
Associate,
Senior Advisor

EXECUTIVE SUMMARY

- *At the end of March, the expansion will officially turn 93 months old – nearly twice as long as the average expansion length of 47 months. However, expansions don't die of old age, and there appears to be plenty of reason to be optimistic about the near-term outlook for the economy.*
- *Job creation remains robust and wages have also been edging higher. The Fed has assumed a more hawkish stance in anticipation of stronger economic growth, determining that the economy may finally have the needed momentum to justify higher interest rates.*
- *Positive economic fundamentals and expectations for favorable tax and spending policies from the Trump administration have increased investor optimism, pushing equity markets higher. However, if lofty expectations fail to materialize, investor sentiment could dim and leave equities vulnerable to a pullback.*
- *In this environment, we recommend that investors take stock of their situation and reaffirm their long-term goals, objectives, tolerance for risk, and desired asset allocation. Within that context, higher stock prices may create opportunities to rebalance portfolios, reduce debt, and/or make charitable gifts using appreciated securities.*
- *As always, having a plan – and knowing what that means in terms of action regardless of market conditions – improves one's probability of success over the long term.*

BLOG

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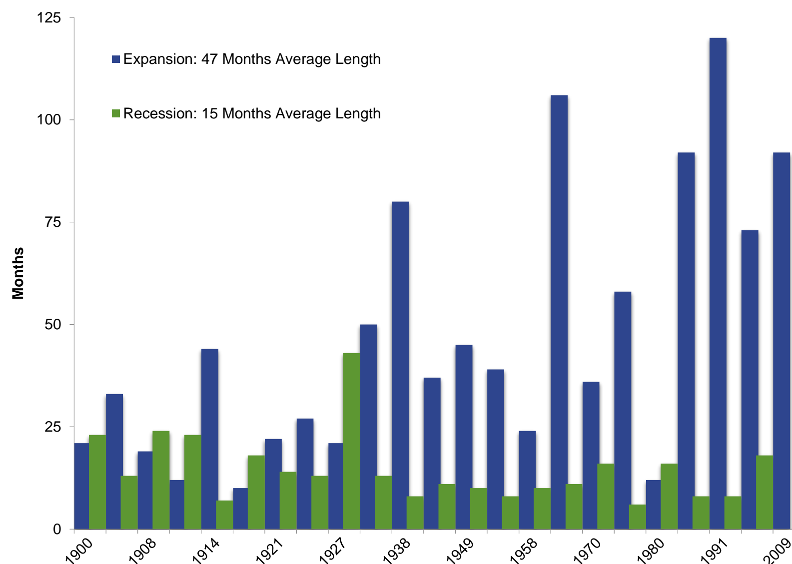
PMFA SPECIAL MARKET COMMENTARY

The Expansion Reaches a Milestone

The current U.S. economic expansion, which began nearly eight years ago, will soon become the third longest since 1900. At the end of March, the expansion will officially turn 93 months old – nearly twice as long as the average expansion length of 47 months. While the economy will at some point experience another recession, there appears to be plenty of reason to be optimistic about the near-term outlook for the economy, its length notwithstanding. After all, expansions don't die of old age.



Source: PMFA, National Bureau of Economic Research

Economy on Stable Ground

When examining the underlying vitals of the economy today, things appear healthy and growing. The employment market remains on solid footing, as the unemployment rate fell to 4.7% in February. Job creation has exceeded 200,000 jobs for each of the past two months. Wages have also been edging higher, rising 2.5% over the past twelve months, even as average hours worked declined slightly. Likewise, soft measures of activity for consumers and small businesses continue to strengthen. Consumer confidence is at its highest level in nearly 16 years – a positive sign for an economy that derives roughly 70% of its activity from consumer spending. Similarly, small business confidence has also risen sharply in recent months, with more businesses indicating plans to expand payrolls and invest in equipment. The manufacturing sector – broadly viewed as a key cyclical sector that is particularly sensitive to the business cycle – has also picked up in recent months and is solidly in expansionary territory.

Perhaps the most telling factor has been the Fed's recent behavior, as it has slowly become more hawkish in response to expectations for stronger economic growth, the recognition that the economy is at

or near full employment, and inflation that is edging closer to its 2% target. The March rate hike represented the second increase in just four months after only one increase in the previous decade. With two more hikes expected this year, the economy may finally have the momentum it needs from the Fed's vantage point.

Overall, the expansion appears to still be very much on track and may even be gaining renewed momentum as a number of recent economic indicators have surprised to the upside. Measured by time alone, the current expansion may seem long in the tooth. However, when measured in terms of magnitude (the cumulative percentage growth since the recessionary trough), the current expansion has been amongst the weakest on record, and there is little evidence to suggest that it is close to overheating. In the absence of the type of noteworthy buildup of excess somewhere in the economy (such as the real estate/housing bubble before the last recession or the tech bubble in the late 90s), it appears that the potential exists for the expansion to continue for some time.

Capital Markets and Portfolio Considerations

Healthy economic fundamentals and increasing investor optimism since the November presidential election has pushed equity markets aggressively higher. Whether the move is predicated on expectations for lower taxes, infrastructure spending, or a more accommodative regulatory environment, investors' collective response to the expected change in policy direction has been resoundingly positive.

Unfortunately, as prices have risen, so have valuations. Nearly every traditional measure suggests stock valuations today are well above their historical averages. While better economic data has played a role, much of the run can be attributed to the sharp improvement in sentiment. In recent months, equity investors have priced in some fairly lofty expectations, including an expected strong rebound in corporate earnings, renewed strength in the economy, and the assumption that President Trump's pro-growth agenda will be signed into law and have a meaningful positive effect on growth.

The failure to rally sufficient Republican support for the health care bill last week may be the first tangible sign of the difficulty ahead. The difficult political reality that will have to be overcome to advance his agenda has been largely overlooked to this point. However, if the prospects for tax and regulatory reform and infrastructure spending sink, investor sentiment is likely to dim, and could leave equities vulnerable to a pullback.

Of course, the potential for volatility is always present with stocks and other risk assets. While equity valuations are elevated today, history suggests that valuations could remain elevated for some time or even move higher from here – particularly in an environment accompanied by low interest rates and modest inflationary pressures. Furthermore, valuations have proven to be a particularly poor timing tool, as prices can remain stretched for an extended period. The vagaries of market cycles are complex and unpredictable, which makes attempting to time the peaks a losing strategy. We believe investors are best served by maintaining a consistent portfolio strategy throughout a full market cycle that aligns with one's stated tolerance for risk, goals, and objectives. Still, there are some proactive steps investors can consider to take advantage of high stock prices.

1. **Rebalance** – A simple, but time proven, strategy, rebalancing provides some discipline around portfolio decision-making. As stock prices rise, they represent a larger percentage of an investor's portfolio. By selling stocks to rebalance to other asset classes such as fixed income, an investor

systematically sells stocks at higher prices while rebalancing to other asset classes that have underperformed. It reinforces the buy low/sell high discipline, while bringing a portfolio's risk level back in line with its strategic target.

2. **Reduce Margin Debt** – Equities have benefited from an extended bull rally; however, elevated valuations are indicative of lower future return expectations. As such, the opportunity cost of paying down outstanding debt is also lower. Consideration should be given to paying off margin debt in particular, and other debt as appropriate.
3. **Charitable Gifting** – The rise in stock prices may have resulted in large, low-basis investments. For investors who are charitably inclined, gifting low-basis stock helps to rebalance risk, receive a charitable deduction for the full value of the security, and avoid capital gains taxes.[1]

Whether the market continues to rally from here or takes a breather, investors would be well served to not allow their emotions to dictate their strategy – regardless of the source. Optimistic investors may feel emboldened by the sharp run-up in equities in a relatively short period and be tempted to increase their equity allocations. Pessimistic investors may believe that President Trump's policies may not be the answer or that growth may disappoint; they may also believe that valuations are so high that markets have little upside left.

The fact of the matter is that even with elevated stock valuations, expected returns over a multi-year timeframe still exceed those associated with cash or bonds. While the path ahead is unclear and volatility will return at some point, it's impossible to time the market. Being out of equities can be very costly, just as being overexposed to equities (beyond one's risk tolerance) can be just as costly if it results in a decision to reduce one's allocations in response to a market pullback.

Instead, we recommend that investors take stock of their situation and reaffirm their long-term goals, objectives, tolerance for risk, and desired asset allocation. As always, having a plan – and knowing what that means in terms of action regardless of market conditions – improves one's probability of success over the long term.

[1] – Every individual's tax circumstances are different. As such, consult with your tax advisor before engaging in transactions that may have an effect on your tax situation.