

November 6, 2017

**BLUME CAPITAL MANAGEMENT**  
**Fourth Quarter Newsletter**

U.S. stocks continued their relentless push higher in the third quarter as the S&P 500 rose for the eighth consecutive quarter (and 19 out of the last 20!). The index gained 4.5% to bring the total year-to-date return for the S&P 500 to 14.2%. It has now been 16 months since we last experienced a 5% pullback, the fourth longest streak in history.

Led by emerging markets, international stocks enjoyed another strong quarter as robust global growth overshadowed geopolitical concerns surrounding North Korea. Moreover, a weak U.S. dollar, continuing momentum in the Chinese economy, and rising commodity prices were all positive for foreign stocks.

U.S. bonds inched higher even as the Federal Reserve announced that it will begin reducing its \$4.5 trillion balance sheet in October. Strong demand from investors helped to support bond prices in the face of tighter monetary policy in the U.S.

INDEX	Third Quarter <i>06/30/17 – 9/30/17</i>	Nine Months YTD <i>12/31/16 – 9/30/17</i>	Twelve Months <i>9/30/16 – 9/30/17</i>
<b>S&amp;P 500</b> <sup>1</sup>	4.5%	14.2%	18.6%
<b>Dow Jones Industrial Average</b> <sup>1</sup>	5.6%	15.5%	25.5%
<b>MSCI ACWI Ex U.S. Index</b> <sup>1</sup>	6.2%	21.1%	19.6%
<b>Barclay’s Intermediate Agg. Bond Index</b>	0.7%	2.3%	0.2%

There are few places in the world where investors haven’t made money in 2017. The synchronized expansion in global economic activity—along with subdued inflation and still accommodative monetary policies—continued to provide a supportive environment for financial markets worldwide. Indeed, for the first time since 2010 global growth has been consistently exceeding economists’ expectations.



<sup>1</sup> Includes dividends in addition to index price appreciation.

More remarkable has been the pronounced lack of volatility in equity markets despite natural disasters, tensions with North Korea, the Trump administration's dysfunction as well as the Las Vegas tragedy. If the world feels more chaotic and dangerous than usual, the markets have not noticed.

Of course, the elephant in the room at this point is how long can the equity market gains continue after nearly a nine year bull market run? The recent lack of volatility in equity markets only adds to a sense of unreality and foreboding around the stock market's ascent.

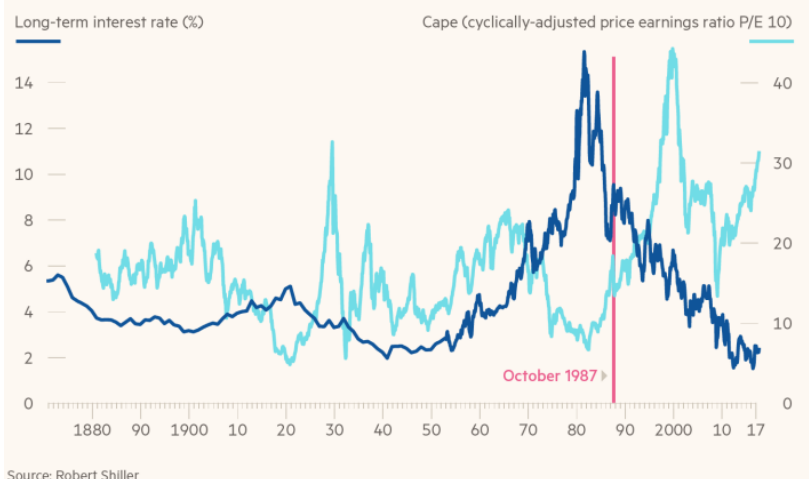
## LOOKING FORWARD

After such an extended run, it is not unreasonable to think we are overdue for a major correction, a recession or both. However, it is important to bear in mind that classic recessionary signals are still not present. Employment growth is reasonably strong. Inflationary pressures, while ticking modestly higher, remain subdued (core CPI<sup>2</sup> is at 1.7% and below the Federal Reserve targeted level of 2%). Lastly, industrial capacity utilization at 76.1% remains well below 80%, the level historically associated with greater pricing pressure. In short, the economy is not currently showing the signs of overheating that would necessitate higher interest rates and typically precede a recession.

The case for sustained stock market gains is more equivocal. Stock market valuations have become stretched with the S&P 500 trading at roughly 18x next year's earnings versus a long-term average of 16x. Moreover, some measures of sentiment are showing elevated levels of investor optimism, which can be an early indicator that a market pullback is looming. Paradoxically, even as investor sentiment is improving, net flows into domestic equity funds (including ETFs) are flat to negative, a contrarian bullish sign for stocks.

While equity valuations are clearly elevated, it is important to remember the fundamental link between interest rates and equity valuations. Specifically, the current low level of interest rates, all else being equal, warrant higher equity price-to-earnings (P/E) multiples. Simply put, an investment in an asset is just a claim on its stream of expected future cash flows. Discounting those cash flows at a lower interest rate supports paying a higher price today (the opposite is also true, i.e., when interest rates rise, valuations decline). As Warren Buffet recently said, "If the government absolutely said interest rates are going to be zero for 50 years, the Dow would be at 100,000."

Valuations: stocks are expensive, bonds even more so



<sup>2</sup> Core CPI is defined as CPI excluding volatile food and energy prices.

Finally, the earnings growth of S&P 500 companies tend to drive equity market returns. After stagnating for nearly two years (2015-16), earnings growth has accelerated in 2017 and consistently exceeded expectations in recent quarters. Which is to say, that although stocks are at all-time highs, a large portion of the recent gains have also been supported by strong earnings growth in the context of an improving U.S. and global economy.

## CLOSING THOUGHTS

We are acutely aware that the central message of our newsletters has been similar for several years running – economic growth is subdued but positive, valuations are elevated but not at extremes, central banks have started to normalize policy but remain accommodative, and prospective equity returns, while low, look better than the alternatives (e.g., bonds). However, do not allow our relatively sanguine outlook about the economy suggest any complacency on our part. The market's continued, seemingly effortless ascent is unsustainable and is making us progressively more wary. There is little doubt that we are overdue for a correction and the current economic expansion is closer to the end than the beginning.

As we have discussed in previous letters and in client meetings, we have made several changes to reduce risk across client portfolios. We have significantly raised the quality of fixed-income investments by reducing our exposure to high-yield bonds. In equity portfolios, we have aggressively trimmed fully valued positions while shifting towards more defensive names. Finally, we have continued to diversify portfolios by rounding out clients' allocation to precious metals (gold and gold miners) as well as added an investment in Weyerhaeuser, the largest publicly-traded owner of timberlands in North America.

It is important to remember that the potential for an overdue correction does not mean that one should run for the hills. As value-oriented investors our goal is always to mitigate downside in client portfolios during bear markets. Indeed, value-oriented investors have successfully protected investors' downside in more traditional downturns, or even made money such as in 2000-2002. In short, we feel strongly that, come what may, client portfolios are well positioned to weather the next down turn.

We hope you are enjoying a lovely fall. Of course, our thoughts are with those coping with the aftermath of the devastating fires in the North Bay.

Sincerely,



Peter B. Reidenbach



Jeffrey V. St. Claire



James B. Blume

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