Advisors

Newsletter 2nd Quarter 2017

FINDING "VALUE" IN THE MARKET

The stock market rally continued in the second quarter with the S&P 500 rising by 3.09%. Growth stocks continued their dominance over value stocks, although that domination started to weaken near the end of the quarter making this development worth monitoring. Small capitalization (cap) stocks continued to struggle relative to large cap stocks. One of the most interesting aspects of the first half of 2017 was the resurgence in international stocks which handily beat U.S. stocks, something that hasn't happened for many years.

Common sense suggests that international stocks should start to outperform U.S. stocks. They trade at lower valuations, have diminished political risks, have more room for improvement in profit margins with the uptick in global growth, and now have earnings momentum. Industry analysts look for international earnings to increase by 18% to 19% this year, compared with an estimated gain of 10% in U.S. profits. Economic data has been strong overseas. Germany's flash purchasing manager index rose to its highest level in six years while Japan's has been improving, and even emerging markets are holding up better than previously expected in the face of the Federal Reserve raising interest rates. Investors remain unconvinced and are underweight international stocks. If overseas stocks continue to outperform investors will likely rush to buy them.

Common sense also suggests value stocks should reassert themselves over growth stocks. Growth stocks have more than doubled value stocks since the beginning of 2015. The outperformance extends even further despite a pretty convincing history of value outperforming growth. From *Barron's:* "On average over the last century, value stocks have markedly outperformed so-called growth stocks—which are those that trade for the highest price-to-book-value ratios. But not since 2005. For performance over the 12 years through April, value has lagged growth by an annualized average of 0.7%, according to data compiled by the University of Chicago's Eugene Fama and Dartmouth College's Kenneth French. **Over the prior eight decades—going back to 1926—value beat growth by an annualized average of 4.8%**."

Not surprisingly in our styles where we own international stocks we are slightly overweight our benchmarks and **for all styles we are tilting our exposure to value stocks.** In fact, it is these opportunities that make us less concerned about a big sell-off than many others. Even with the S&P 500 near all-time highs two out of every five stocks are below their 50-day moving averages and are attractively valued. Case in point is the stock we added this quarter –JPMorgan Chase. When we purchased it in early June it was below its 50-day and 200-day moving average, only 11.2 times forward earnings, 1.3 times book value and sported a 2.4% dividend yield.

Besides the juicy returns the other big story has been the absence of volatility. In the first three months of 2017, the average daily move of the S&P 500 was the lowest since the 1960s. And it's not just a U.S. phenomenon. Financial markets across the globe are eerily calm. Why has this happened? Although there are theories, no one knows for sure. We just chalk it up to randomness, a characteristic found a lot in financial markets. **However, volatility has historically tended to cluster, so if it begins to pick up, we will take notice and may adjust the portfolios accordingly. But until then the path of least resistance for stocks appears to be higher.**

James Tillar, CFA and Steve Wenstrup

OUTSIDE COMMENTARY

Wall Street Journal

FED "Stress Tests" Clears All Banks to Issue Payments to Shareholders

Ryan Tracy, June 28, 2017 (Excerpt)

Big U.S. banks plan to increase dividend payouts and share buybacks to their highest levels in years after the Federal Reserve on Wednesday approved capital plans for all 34 firms taking part in its annual stress tests.

The approvals—the first time since the annual tests began in 2011 that all firms got passing grades—reflect a turning point for big financial institutions that have been shackled by tighter regulation since the financial crisis. They could also herald a return to precrisis days when banks were reliable dividend payers and shareholders flocked to them.

Bank of America Corp., for example, said that it would increase its dividend by 60% to 12 cents a share per quarter, putting it above a threshold where Warren Buffett's Berkshire Hathaway Inc. may convert a stake in the firm into common stock and become the bank's largest shareholder. The second-biggest U.S. bank by assets also said it received approval to repurchase up to $12.9 billion of its shares, far above the $7.7 billion it bought back over the previous year.

On average, the group of firms taking part in the stress tests requested payouts that are near 100% of their expected earnings over the next year, up from 65% last year, senior Fed officials said. That means banks in some cases will be able to start whittling away at capital buffers that many bank executives say are well in excess of what is needed to absorb potential losses.