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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

Throughout the past quarter, the financial press frequently proclaimed that one or more of the many equity benchmarks had again attained a new record level. The reaction of many of our clients was to question whether we should be selling stocks. We addressed this question during our recent Northern California Client Appreciation event, and would like to share our response here.

The short answer to the question is, "No!" Unlike real assets, such as commodities and real estate which have static values, e.g. an ounce of gold will be worth whatever someone is willing to pay for an ounce of gold, now or in the future; the ownership of stock provides an investor with a claim to a portion of all the future earnings of a company. **In other words, stocks have a dynamic value based on the company's ability to grow its earnings.**

The most common measure of valuation for stocks is the price to earnings (P/E) ratio, where the price reflects the market's perception of the present value of a discounted stream of all of a company's future earnings. If I may take a slight detour, the rate which is used to discount these future earnings may be interest rates or the rate of inflation, or both. With interest rates and inflation at historically low levels, the future stream of earnings will be discounted back to a higher present value, which justifies a higher price as well as a higher price to earnings ratio. **We fully expect both interest rates and inflation to rise moderately in the coming years. This is likely to pressure the P/E ratio of the broad market to decline modestly to more normal or average levels.**

But stocks are dynamic financial assets. **Slightly higher inflation will tend to be partially embedded in a higher growth rate of a company's earnings, so that even if a company's P/E ratio declines, higher earnings will support a higher stock price.** Perhaps the best way to explain the power of earnings growth is by example: if a company has a P/E multiple of 15 times earnings and the company earns $1 per share, the price of the company's stock is $15. Now, assume those earnings grow at 10% per year; at the end of 7 years the company's earnings will have almost doubled and the company will be earning nearly $2 per share. If we use the same P/E multiple, the stock will be worth nearly $30. That is why it is perfectly normal for stock indices to regularly attain new highs, so long as earnings continue to grow.

While this is already the fourth longest economic expansion since World War II, it has also been the slowest. **Because the slow pace of this recovery has not produced the excess which leads to a recession, it is quite possible that this recovery could go on to become the longest.** In a recent interview, shortly before retiring as President of the Atlanta Federal Reserve Bank, Dennis Lockhart described post 2008 regulation as like a pendulum which perhaps swung too far and may now be swinging back. Certainly regulation has been a contributing factor in the slow pace of the current expansion, and regulatory relief could serve to increase the pace of economic activity.

But, the current market environment is already fundamentally positive for earnings and stock prices. For the past several years, the economic recovery in the United States has been anemic in the midst of a global recession. This year, leading indicators are consistent with a forecast for world GDP growth of around 3.5%. **Where global growth has been a drag on domestic growth in the U.S. these past years, we expect it to stimulate growth in the coming year.**

Also, in these past few years, the slow pace of the recovery has allowed many structural improvements which may further stimulate an acceleration of economic activity as the expansion continues. Energy is now abundant, cheap, and domestically sourced, compared to a few years ago. Financial liquidity is abundant with banks well capitalized, corporate cash near record levels, and household balance sheets much improved. Housing is in short supply with housing starts continuing to rise. The labor market is strong with wages beginning to improve; consumer confidence is high and consumers are spending.

While the stars seem to be aligned for a continued rebound in earnings growth, at least for the remainder of this year, the prospects for this expansion continuing well into the future will be contingent on regulatory relief and fiscal stimulus. In a perfect world, we could even see the economy growing at a faster pace as it recovers its lost potential. Our only worry then would be an overheating economy with the risk of the Federal Reserve overreacting with restrictive monetary policy. But we are a long way from that being an issue.

Fixed Income

During its March meeting, the Federal Open Market Committee (FOMC) raised the fed funds target by another 25 basis points (bps) to a range between 0.75% and 1.00%. The 25 bps hike was the third increase since the target was first raised from the unprecedented 0% level following the financial crisis. Chair Janet Yellen stated that the increase was simply a continuation of the gradual tightening planned by the Fed and did “not reflect a reassessment of the economic outlook or of the appropriate course for monetary policy.” **The key message with the Fed’s recent rate hike is that the economy is evolving in line with its forecasts and as a result the Fed is following through on its planned rate hikes to normalize monetary policy.**

The Fed’s decision to increase rates was widely anticipated given the statements made by FOMC members prior to the March meeting. It is clear the Fed does not want to alarm the market. As a result, the market is more focused on how quickly the Fed will continue to raise interest rates over the next few years. Since the first rate increase in late 2015, the Fed has frequently delayed planned rate hikes; at the start of 2016, the FOMC expected to raise the target rate four times during the year, but ended up raising the rate only once, at the end of the year. With the Fed now closer to reaching its stated goal of full employment with price stability, it may be harder to delay the process of normalizing monetary policy; the unemployment rate is expected to remain at 4.5% and both headline and core PCE (Personal Consumption Expenditures less Food and Energy) inflation are expected to reach the 2% target by 2018. Over the next three years, the market projection expects three rate hikes per year, bringing the target rate close to the Fed’s forecast for a longer term funds rate of 3.0% by the end of 2019. **If the current interest rate forecast holds, rates may continue to remain at a historically low and stimulative level over the next three years.**

The FOMC has continued to shift its emphasis to current and expected inflation levels to determine future rate hikes. The Fed’s preferred measure of inflation, the Core PCE Price Index, indicates core inflation is still below the 2% target that is consistent with expectations for long run price stability. **However, overall inflation continues to trend gradually higher, and if economic growth continues to persist, there may eventually be a meaningful pick-up in inflation.**

International Market

Globalization, broadly defined, is the free movement of goods, services, capital, and people. **While headlines about “the end of globalization” cast recent, proposed, changes as disastrous, the scaling back of globalization may in fact be beneficial to economic growth and thus welcomed by equity markets.** The media’s negative view comes as a reaction to the rising influence of populism, an ideology used to describe “a rebellion of the common man against the elites, and to some extent, against the system.” Over the last few years, the ideologies of populism have gained traction in developed countries around the world and have arguably picked up momentum after Brexit and the election of President Trump. Many believe this phenomenon will lead to the implementation of protectionist policies, i.e. anti-trade policies that protect domestic economies from foreign competition, leading to isolationism and the collapse of globalization.

Is the age of globalization coming to an end? We do not believe so. Globalization has arguably increased aggregate wealth for the global economy, but not everyone has benefited equally and some have ended up disadvantaged. Trade is a chief concern for those who have suffered job loss and lower wages, and who argue that globalization and neoliberal trade policies are to blame. The new U.S. administration has stated its intention to take a much more assertive stance toward trade negotiations, while in other developed countries, political opposition to free trade is also on the rise. However, even if trade volumes do decline, in this political environment, the global supply chains which intricately impact people’s daily lives would be difficult to unwind and technological change will continue. **On the positive side, the threat of potential changes to U.S. trade policy may help slow the decline of U.S. manufacturing employment and discourage U.S. companies from outsourcing.**

Globalization is facing a strong headwind and how President Trump handles trade relations will indicate whether he aims to revolutionize U.S. trade policy to the detriment of global exports and growth. **But, despite the negative impact of potential de-globalization, a pause in this relentless force may not be such a bad thing after all.**

According to the Swiss Economic Institute’s KOF Globalization Index, an upward trend of increasing worldwide integration began in 1981. This wave of globalization coincided with a decrease in the U.S. Consumer Price Index during the same period; a drop from roughly 10% to below 2%. **This inverse correlation should be expected, as globalization is deflationary in nature; the key fundamental of globalization is for manufacturing of goods and delivery of services to come from places with lower cost structures. Both academic theory and historical data have shown, all else being equal, that deflation is a much worse enemy to economic growth and equity markets than inflation.** A prime example would be Japan’s “lost decade”; for a prolonged period of time Japan has experienced a downward spiral of deflation, and both its economy and stock market have been negatively impacted as a result.

If the globalization of the world economy has indeed peaked, it would, in theory, remove significant deflationary pressure and reintroduce moderate levels of inflation. De-globalization could help the economy to reaccelerate, and recent inflation data has confirmed this expectation. Raw material industrial prices, a proxy for inflation, have inched up and the recent upward trend in Global Manufacturing PMI (Purchasing Managers Index) data indicates economic activity expansion. Further, the recent PMI readings of nearly all the major advanced and emerging economies have shown encouraging levels. In aggregate, the highly regarded Markit’s Global Manufacturing PMI edged up to 52.9 during the quarter, reaching its highest level since 2011.

Even China, a country that many believe will bear the brunt of protectionist sentiment, seems to be weathering this storm quite well. **The combination of China’s accommodative fiscal and monetary policies has helped to sustain a continuation of a strong policy-driven rebound.** According to China’s National Bureau of Statistics, rising producer price data has reversed the deflationary trend it experienced in recent years while industrial activity has picked up steam. **The U.S.’s top trading partner, the European Union, has also shown signs of resilience to the current trend of de-globalization.** The European government’s move away from restrictive fiscal policy, improving economic activity as measured by PMI data, and indications that households are no longer reducing their debt ratios are all positive for major European economies.

The world is facing an economic environment unlike any for at least the past three decades, and therefore it is expected that the level of uncertainty will be high. **However, as we analyze current economic trends, we believe the global trade environment is being portrayed more negatively than the data suggest.** Given this backdrop, we believe an acceptable exposure to international assets is still warranted as a prudent investment strategy.