KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Spring 2017

The first three months of 2017 were a case study in juxtaposition. Largely due to optimism tied to potential fiscal stimulus, financial assets have performed well, measures of riskiness have declined, and economic optimism gauges have strengthened. This happy set of results has occurred despite starting from a point of relatively full valuations across most asset classes. This starting point is significant, because the starting valuation of an asset is the greatest indicator of its expected future return *and* the amount of risk taken to earn that return. The starting point in 2017 implied expectations for a pickup in growth, declining risk, or permanently lower interest rates.

The increase in valuation of assets from economically sensitive companies was dubbed "The Trump Trade" as financial markets appeared to focus on the positive effects on equity prices of the new administration's economic policies, particularly those due to talk of broad tax cuts, the reversal of various regulations across a number of industries, and a large increase in infrastructure spending. Irrespective of political views, less regulation, infrastructure spending, and tax reductions are a generally accepted prescription for a pickup in short-term economic growth. Of course, the key question is what are the odds these policies will be enacted?

The equity market's reaction has been telling. Stocks[1] have appreciated approximately 6% year-to-date. Concurrently, margin borrowing hit a 58-year high, while the Conference Board's latest reading of American Household Optimism reached a 17-year high. More so, as judged by the VIX, a measure of volatility and colloquially described as the "fear gauge" on Wall Street, the first quarter of 2017 has been the calmest three months in the stock market in over 10 years. In essence, stocks have gone up, fear is near an all-time low, and people have rarely felt more optimistic about the future. By all appearances, the equity markets are suggesting a high probability that the Trump administration will succeed in enacting its perceived policy goals.

Despite this optimism, political discord appears to have reached a new high, as was starkly illustrated by the recent failed attempt to repeal and replace the Patient Protection and Affordable Care Act (aka "Obamacare") even though the Republican Party controls the House, Senate, and the White House. This failure suggests, at a minimum, that enacting the administration's economic policies is hardly the lock financial markets have thus far predicted.

At the same time, the Federal Reserve continued raising short-term interest rates. This is generally viewed as a positive development because it indicates the Fed believes the economy is strong enough to continue growing with less assistance from accommodative interest rate policy and the odds of inflation reaching the Fed's 2% target are gaining. However, the theme of conflicting indicators

[1] As represented by the S&P 500

continued as long-term rates actually *declined* following the Fed's decision. When short-term interest rates are rising while long-term rates are falling, this is known as a flattening yield curve and it generally portends slower future economic growth.

Current Portfolio Positioning

As we discussed last quarter, we continue to view our primary job as maintaining a disciplined approach to managing our clients' portfolios where valuation is the bedrock of all investment decisions. The current environment contrasts higher-than-average valuations across most asset classes with the potential for fiscal stimulus and a reduction in corporate tax rates. While the probabilities of these actions have been declining, they are still substantial and could ultimately justify the high starting point of valuations.

When future returns are most dependent on economic growth, as opposed to mean reversion of unusually low valuation, we believe it is most important to guard against a permanent loss of capital while opportunistically focusing on high quality opportunities. We are invested side-by-side with our clients and will continue to be more than happy to take a pass on investments with inferior return prospects and elevated odds of losing money. Across our strategies we are positioned as follows:

1. In equities, we remain defensively positioned with cash levels rising as we have been trimming stocks that have reached our fair value estimates. This is discussed in more detail in our accompanying Core Equity commentary.
2. In fixed income, we have begun to modestly lengthen the duration of portfolios as interest rates have risen. As always, we are maintaining very high levels of credit quality and, as always, we refuse to reach for yield at the expense of a possible impairment of principal. Please read more about this in our accompanying Fixed Income commentary.
3. Where appropriate, we continue to recommend the inclusion of some alternatives (hedged equity, real estate, etc.), where a more suitable risk/reward profile might exist. An enhanced risk/reward profile often results as a tradeoff for assuming less liquidity than in the public markets.

As always, please discuss your particular situation with your KIG financial advisor.

Best Regards,

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