KOVITZ INVESTMENT GROUP
Intrinsic Values®

Market Insights
Fall 2017

The third quarter of 2017 saw the continuation of many of the same market characteristics we have observed over the last year. First, equities continued to appreciate and now trade at or near all-time highs. Second, volatility (as discussed in our last newsletter) has continued to remain unusually subdued. Third, interest rates remain historically low, and debate continues regarding the prospects for higher rates and a steeper interest rate curve.

In contrast to the placid financial markets, the third quarter was marked by a continued escalation of geopolitical and policy risks. These risks include: rising tensions between the U.S. and North Korea; continued confusion over domestic inflation that is persistently below expectations; uncertainty over the future course of the Federal Reserve's monetary policy, which is compounded by the uncertainty of who will be appointed to be the next leader of the Federal Reserve after Janet Yellen's current term ends; continued risk posed by elevated valuations across most asset classes; and continued risks posed by the polarization of domestic politics.

Normally, these sorts of risks would lead to heightened volatility, but that has been far from the case over the last year. In our opinion, the key issue at hand remains the low interest rate environment. After 8 ½ years of an uninterrupted bull market, it is easy to believe interest rates will forever be low. While there are many arguments to explain the persistence of the low interest rate environment, there are also many reasons to believe it will eventually end. Chief among these is the potential for fiscal stimulus.

While most media coverage of potential tax reform and infrastructure spending is presented through a political lens, we believe the topic should not be nearly as controversial as it seems. The low interest rate environment since the financial crisis has been characterized by a weak demand for money. In other words, even though the price of money, as reflected by prevailing interest rates, has been set at a very low level (think of low mortgage rates, attractive rates on car loans, attractive rates on business lines of credit, etc.), the demand to borrow money has been noticeably weaker than expected. Given this set of circumstances, most economists would agree that fiscal stimulus would increase demand for money and help begin a virtuous cycle of increased economic growth.

This is particularly relevant today because asset prices largely imply interest rates will remain at their current levels for a very long time. While fiscal stimulus could provide the impetus for interest rates to rise, this scenario is not without its own set of risks. Stronger economic growth would help improve the bottom line of most companies, but the starting prices of many asset classes are already reflecting expectations of stronger economic growth, lower corporate tax rates, *and* low interest rates. Therefore, the main risk facing an investor today is that future returns have been pulled forward. If one or more of these factors fails to meet expectations, many assets are simply overpriced and will be susceptible to a loss.

Current Portfolio Positioning

In light of the above discussion, we have continued to maintain our risk management criteria and have not changed the valuations we are willing to pay to invest in any asset class. 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. We are invested side-by-side with our clients and we are 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. We were able to find two new attractive opportunities, which are discussed in much greater detail in our accompanying Core Equity commentary.
2. In fixed income, we also remain conservatively positioned. In reaction to the flattening yield curve, which means the difference in yield between shorter and longer bonds has declined, we have taken the additional step of overweighting near-term maturities in our clients' bond ladders, while underweighting longer-term maturities. Additional background on this decision can be found 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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