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Midwest Investment Management

PERSPECTIVE™

INVESTMENT COMMITTEE PANEL DISCUSSION

Our Analysis of Worldwide Economic Data And The Impact On The Market

Editor: In March, all six members of Midwest Investment Management's Investment Committee met to analyze and discuss the market run-up that began on November 9, 2016. A summary of their observations, comments, and insight are included in this report.

Let's begin by asking how the investment markets have changed over the past 12 months, since March of 2016.

Peter Vanden Broeck: By early 2016, growth stocks had widely outperformed value stocks for some time. This situation was reversed dramatically in the second half of 2016. Sectors such as banks and industrials reacted strongly to post-election hopes of a more business-friendly administration and the prospect of future fiscal stimulus.

Vanden Broeck

As I see it, the market has done what it always has; it reverted to the mean. The gap in valuations between momentum-based growth stocks and the value-oriented banks and industrials, as a group, has shrunk dramatically. A lot of momentum-based systems of investing didn't do well in 2016. However, 2016 ended as a good year for people who bought stocks based on valuation. A year ago, we saw many stocks or asset classes that were out of favor. We don't see a similar landscape now, however.

Norm Klopp

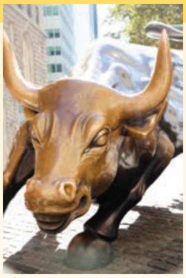
Norm Klopp: The market's transition over the past 12 months from pessimism to euphoria suggests that so many stocks have reverted to the mean that it's hard to see positives not factored in. In this environment, it's more challenging to identify value in individual stocks.

Editor: Is the market currently focused only on the positive attributes of President Trump's policies while ignoring the negatives such as tariffs and border taxes?

Al Meszaros: What we might have now is a looming disappointment in this market, compared to 2016. The market run-up following President Trump's election was based on the ideas of tax cuts, deregulation, and capital repatriation. If there's a delay or disappointment in either the timing or the magnitude of those expectations, the market can be set-up for a decline. If some of the President's promises, such as tax reform, are not delivered until the fall or later, investors may not be happy.

(Continued on page 2)

How Long Can The Bull Market Continue?



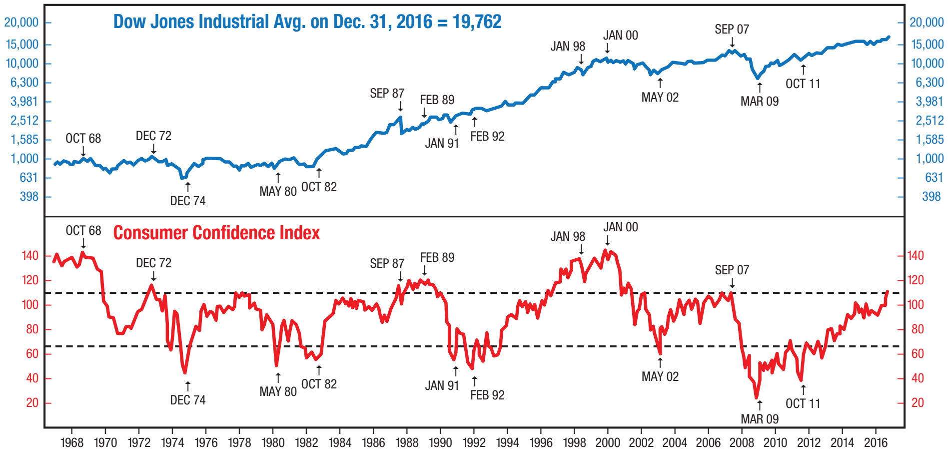
Norm Klopp assesses the stated Trump agenda, its impact on the US economy and the markets.

See his report on Page 4

"If there's a delay… the market can be set-up for a decline."

Dow Jones Industrial Average vs. Consumer Confidence Index

Feb. 28, 1967–Dec. 31, 2016



Source: Ned Davis Research

Panel Discussion… *(continued from page 1)*

> **"…the level of overall risk has increased from a year ago."**

> **"China has a lot of corporate debt, the most in the world…"**

I think the market would likely have a negative reaction to tariffs or a border tax. This could be an offset, or at least a partial offset, to the market's positive expectations that resulted when President Trump was elected. A border tax would increase the cost of goods imported into the US. As we talk here in March 2017, overall public expectations are high, consumer sentiment is high, consumer confidence is at a 15-year high (see the chart on page 1), and stock valuations are elevated. Although these valuations can be justified by certain measures, such as relative to inflation, the level of overall risk has increased from a year ago.

However the odds of a border tax being enacted sit at about 40%, as of now. A border tax would be very complicated and if not implemented correctly could result, in the worst case, a trade war which is currently not expected.

Editor: In the "near term", what other economic factors does this committee see?

Vanden Broeck: In terms of current consumer spending, household formation and employment levels are still very strong. But US home construction rates are not at a peak and mortgage costs are about 10% higher than a year ago. Car and light truck sales in the US are now showing signs of weakness.

Meg Halloran

Halloran: Another negative blip on our radar screen is China. Economic data we're studying indicates that China's economy is slowing. If China continues to move from an investment-based economy to a consumption-based economy, the effects will be felt here in the US. Because of China's vast size and large population, the effects here in the US could be significant.

Keith Vargo: Slower growth in China would likely have a negative impact on a number of industries worldwide. The automotive industry would be one such example. Strong auto sales in the US, China, and Europe drove global auto sales to an all-time high in 2016. The US and China alone accounted for 80% of auto sales in the past several years. For 2017, the global picture looks challenging. Rising gasoline prices in the Eurozone will be a headwind to auto sales. Japan is facing the same. Auto sales in Brazil and Russia have been in a steady decline. The two biggest drivers of global auto sales—the US and China—will likely be a drag on total global sales going forward. China is facing headwinds due to an increase in its auto sales tax. We saw strong auto sales in China in the last quarter of 2016 as people purchased ahead of the tax increase, which pulled sales from 2017. Here in the US, delinquency rates have been rising. This has led banks to tighten lending standards, which will put further downward pressure on auto sales. Up to this point, auto sales have been a contributing factor to global growth but with the likelihood of weakness in the US and China, global auto sales are likely to stall. Weaker auto sales will keep pricing under pressure. To sum it up, declining auto sales will likely put downward pressure on global manufacturing and global inflation.

Meszaros: We could see more risk to the markets if China's economy continues to slow. China has a lot of corporate debt, the most in the world, with a huge amount of bad loans from "zombie companies" kept alive by the government. The ramifications could be significant, because if Chinese currency falls, or continues to fall as the US dollar gets better, or if the Chinese decide to devalue their currency by 10% or 15% in order to become more competitive on trade, we could foresee a capital flight out of China and a financial crisis in that part of the world. This would be a "tail risk," something with low odds of occurring but potentially a big impact if it does.

Bob Yaroma: I see two more tail risks. US Government debt is now at the highest level in history, except during World War Two. Any action the US government takes to stimulate the economy will have a tall mountain to climb. Even if we get tax cuts, they're less effective in the current high-debt economy. Another tail risk is the negative interest rate policies that exist around the world. I'm not speaking only of zero interest rates, but *negative interest rates* that can create uneasiness everywhere as people ask when this situation will end. These are long-term negatives on top of the short-term uncertainties that have been mentioned here.

Bob Yaroma

Halloran: Allow me to offer some final thoughts on China, because it's a factor that shouldn't be ignored. We hope there's no political upheaval in China this year because of the widespread negative effects it could have on the Chinese economy. Despite government attempts to counter political dissent and riots across different towns and cities across China, dissent has continued. If things go out of control, we could see a flight of capital from China, which could be dangerous to world trade. The effects on stock markets worldwide could be significant.

Editor: Are any "long-term" economic factors under scrutiny?

Klopp: Japan has had 25 years of stagnant economic growth with no overall wage increases. Some people have suggested that the US is entering this same kind of environment. By analyzing US demographic data, you could conclude that the US actually has entered a similar stagnation period. In addition, the last eight or ten years of below-trend economic growth in the US are contrary to US economic growth over the past 70 years. Over that period the economy grew at a 3.2% annual rate. Data we've analyzed suggests the economy might grow about 3% this

Current Absolute Variations for the S&P 500 Index are Higher Than the Historic Average of 16.4

Forward Price/Earnings (P/E) Ratios January 2007–March 2017

Source: Baseline

Panel Discussion… *(continued from page 2)*

year, which is a positive tailwind. The Japanese government has spent very heavily to get its economy out of the doldrums, but all they have to show for it is debt-to-GDP ratio at 280%, and still stagnation in wages exists. This underscores the idea among some economists that a study of worldwide demographics suggests lower overall economic growth.

In the past, many economists believed that population growth plus productivity growth equaled GDP growth. But with the US population currently growing at about 0.7% and productivity growing at only 1.1%, GDP growth might continue at below long-term trends. I also want to note that the 25-54 age group in the US is not growing. This removes 1% out of GDP growth over the foreseeable future.

Al Meszaros

Meszaros: An additional problem is that the years 25-54 are considered the prime working years, yet 23 million Americans in that age group are not working. This means no labor output, no productivity. Meanwhile, another contributor to productivity is capital investment, which in recent years has been very low in the US. Another problem affecting the US economy is one we've discussed a few times in this newsletter, namely the huge number of American jobs that go unfilled every year, either because people lack basic job skills or they simply aren't interested in working. Survey after survey confirm that small business owners in the US cite the lack of qualified workers as a major problem they face in operating or expanding their business. This issue affects GDP growth directly.

Vargo: Another factor we're examining is the aging of America's "baby boomers" who are hitting retirement age. Retirees typically don't contribute as much to the economy as full-time workers do. Without a steady stream of earned income, they tend to spend less in retirement than they did in their working years. This is compounded by the fact that most baby boomers don't have significant savings to fund their retirement years. About 1.5 million Americans hit age 70 every year and half of them have savings of only $100,000 or less. This problem is exacerbated because interest rates are so low, with banks paying slightly above 0% interest on savings accounts and CDs, thus crimping their ability to spend.

Klopp: President Trump has a goal of 3% growth in the US GDP, something not seen in many, many years. However, to achieve 3% growth, we'll need economic growth to accelerate quickly, mainly to offset increases in federal spending and budget problems. For sure, the world is changing. We saw unexpected results from the Brexit vote last June and again when President Trump was elected. It's now possible that the French will vote to leave the European Union. Maybe this is a manifestation of the feelings of the middle class around the world. These factors and others create fertile ground for political upheaval.

Editor: What do current valuations look like and what factors could impact valuations going forward?

Vanden Broeck: The recent run-up in stocks was based on the assumption that US interest rates would rise gradually. This is still the case, especially with rates in Europe at ultra-low levels. The Fed can get too big of a gap between rates in Europe and rates in the US. That would be very disruptive. Also, any change in European monetary policy would have profound changes in the US as our bond markets react. For example, after the Brexit vote in the UK, the stock markets in both the UK and the US did better.

Keith Vargo

Vargo: Well, today we're holding about 15% cash in client portfolios. This is a direct result of the current environment regarding stock valuations overall. We view the market to be extended and we're finding a number of our stocks hitting fair value. As a result, we have been selling into the strength, trimming positions and increasing cash levels. As of this date, we're looking for a market correction, a pull-back within what we continue to view as a long-term bull market.

Yaroma: As we know, there's nothing to prevent a 10% correction from current levels, based on some disappointment or just one factor that causes upward momentum to fall for a short period. It wouldn't surprise me to see a correction in the near term, but that correction would provide an opportunity to buy stocks for our clients at a lower price. If Congress and President Trump eventually come to terms on a corporate tax cut, this could benefit many companies that currently pay a federal tax rate of 35%. It could enhance their bottom line. One sector of the market we're watching closely involves bank stocks because of uncertainty over pending Fed rate hikes and inflation.

Meszaros: Absolute valuations for the Standard and Poor's 500 Index at 18.4 times forward earnings (see chart above) are higher than the historic average of 16.4 and the ten-year median of 14.8. Yet, it's important to relate the P/E to inflation, because there's a direct relationship. When inflation runs below 3%, the P/E has averaged 19 times earnings, slightly above today's level. This makes sense because a 17.9 P/E ratio equates to a 5.6% earnings yield (100/17.9 = 5.6). Subtracting expected inflation of 2.5% leaves us with 3% real earnings yield over inflation, slightly above the historical real yield. If inflation decreases further, P/Es can actually increase from current levels.

Vanden Broeck: The recent run-up in stocks was based on several assumptions. First, that US interest rates would rise gradually and this is still the case, especially with rates in Europe at ultra-low levels. Janet Yellen, chairman of the Federal Reserve Bank confirmed as much recently when she announced the Central Bank's intention to normalize monetary policy. This means moving the policy from being "accommodative" to "neutral." In her statement, the Fed expects to make three 25-basis-point increases over the current year. As such, it appears that the market can withstand such a scenario despite what appears to be historically rich valuations. Second, fiscal policy from Washington will be much more business-friendly and supportive of economic growth. Should interest rates move up much faster than expected and or policies fall short of expectations, then we would need to adjust our market assumptions. However, if the current interest rate environment persists, stock prices would not be considered in "bubble" territory.

Editor: This information has been very informative. I want to thank the members of the Investment Committee for participating in this discussion.

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1st Quarter Economic Review

Confidence Among Consumers And Business Owners Increases, But Delays Of Trump Agenda Pose Possible Risk

By Norman F. Klopp, CFA, Managing Partner

Norm Klopp

The stock rally that began following the November election continued through the first quarter of 2017. Many market indexes reached new, all-time highs. As we discussed in the previous issue of this newsletter, this rally was driven by the expectation that two early actions of the Trump administration—lower business taxes and reduced business regulation—would become reality.

Those expectations drove significant increases in business confidence as expressed in the NFIB Survey of small business firms and the CEO Survey of large companies. These high levels of confidence are usually good pre-cursors of accelerations in hiring, capital spending, and increased revenues.

However, we note that the higher levels of business confidence were accompanied with unusually high levels of business "uncertainty" as measured by the same surveys. *This is not a typical pattern.* We note that during the early years of the Reagan administration, business optimism was high and uncertainty was low.

The combination of high business confidence combined with high uncertainty point to a high level of hope—hope that the promises of the new administration will be met on a timely basis. We doubt that significant corporate actions, such increased capital spending, will take place based on hope.

Serious risk ahead?

This highlights the point that we discussed in the Winter issuer of this newsletter, namely that the greatest near-term (2017) risk in Trump administration's policies is timing. All of the major policy initiatives—such as medical funding, major tax reform, and spending changes—will, in our opinion, take much longer to implement than is now generally expected.

This sets the market and perhaps the economy up for periodic and perhaps prolonged disappointment. *This is a serious risk.*

American consumers are in much the same position as business executives. Consumer confidence is up since the election, payroll employment gains are strong, and average hourly earnings are up. But consumer inflation has accelerated and, as a result, real income is under pressure.

Real personal income, the actual dollars a consumer has to spend, drives real consumer spending. Real personal income is expected to grow about 1.5% this quarter, so it is no surprise that real consumer spending is also projected to grow at the same 1.5% rate. Confidence is up but uncertainty is also up and consumers remain very conservative in executing their spending and savings plans.

Fed rate hike

Led by what it indicated were signs "that economic activity has continued to expand at a moderate pace" the Federal Reserve Board raised the federal funds rate another 0.25% to 1.00% at its meeting on March 15. This increase was widely anticipated by the financial markets. It represents a continued move toward what would be considered interest rate "normalization" after a long period of abnormally low rates. It also is another step in continued global central bank tightening. This trend must be watched closely because it could represent an approaching topping-out of global economic activity.

We do not expect much change in the rate of domestic real GDP growth as the year progresses. Quarterly growth could be in the 2.0% to 2.5% rate. If the Consumer Price Index inflation moves above 2%, this would imply nominal GDP would be flat. This would likely restrain nominal personal income growth and consumer spending.

Our overall insight

This issue of the Perspective is entirely dedicated to a summary of a recent round table discussion our Investment Committee had dealing with some of the longer term factors that might impact the economy.

It is rather "free form" in structure as many such discussions are, but it does present good insight into what is on "our collective minds" relative to the longer term outlook for the stock market and the economy. We welcome any questions or comments you might have on our thoughts.

We hope you enjoy reading our quarterly newsletter, which contains news about our firm, its investment philosophy, the economy and market trends. We suggest you retain these newsletters for future reference.

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