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WEALTH MANAGEMENT
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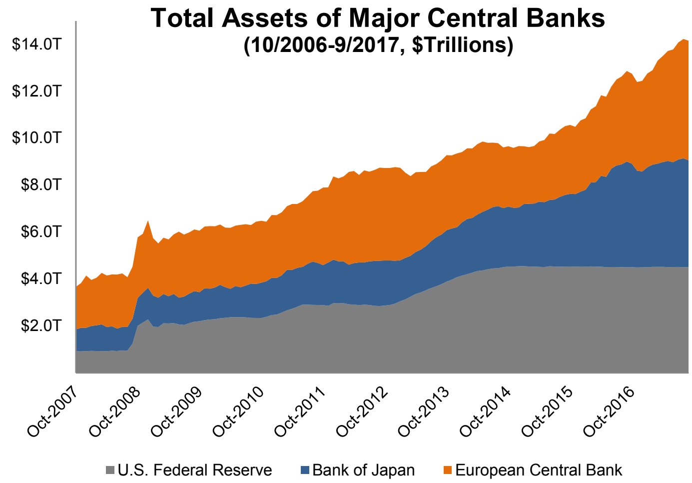
The Bionic Market—Better, Stronger, Faster!

"We can rebuild him. We have the technology. We have the capability to make the world's first bionic man. Steve Austin will be that man. Better than he was before. Better, stronger, faster."

Intro to The Six Million Dollar Man, 1974–1978.



Source: Bloomberg

In The Six Million Dollar Man, astronaut Steve Austin is on life support in the wake of a crash. The powers that be pull out all the stops to save Austin, giving him a bionic left eye, legs and right arm. It's the ultimate fusion of man and machine. His girlfriend suffers a parachuting accident and later becomes The Bionic Woman.

These cult 70's hits come to mind as the global economy is firing on all cylinders. Nearly all countries (94% globally) are showing positive economic growth. On top of that, more than half of all countries (61%) are showing accelerating growth.[a]

The S&P 500 has notched 43 new highs in 2017 through October 5th[b] with volatility at half of normal levels[c]. Non-U.S. equity markets have posted even stronger returns. Interest rates have stayed low.

Some view this strength as unnatural, even bionic. They point to the 'nontraditional' actions that Central Banks undertook in the midst of The Great Recession of 2008; first by cutting interest rates to 0% and then conducting Quantitative Easing – an outright buying of bonds and other assets in an effort to stimulate the economy and resuscitate employment.

Despite this widespread economic growth and 'easy' money, inflation has been noticeably absent. Traditionally, this kind of economic growth amid full employment has sparked inflation that has caused the Federal Reserve to tighten policy. Yet wage growth is fairly quiet at 2.4%[d].

All eyes are on the Federal Reserve (Fed) as it looks to reduce the size of its balance sheet (by about $10 billion per month) and consider raising rates. Expectations are for a 0.25% hike in December which would bring the Fed Funds rate to 1.25-1.5%[c].

a. Goldman Sachs Asset Management, Q4 2017.
b. Shell, Adam. "S&P 500's New-High Streak Best in 20 Years". USA Today. 7, October, 2017.
c. Bloomberg, S&P 500 Historical Volatility, 10/10/07-10/10/17.
d. U.S. Bureau of Labor Statistics, Civilian Workers Compensation, 12 month change. Q2 2017.

With current Federal Reserve chair Janet Yellen's term expiring in February, attention is focused on who next will lead the Fed. While Yellen is in the mix, President Trump has also met with National Economic Council Director Gary Cohn, Fed board governor Jerome Powell and former Fed governor Kevin Warsh. Each has their own views on monetary policy, tilting hawkish or dovish, and the role of the Fed in regulating the banking sector. The market hates uncertainty and it's reasonable to suspect there will be an adjustment period for any new leader.

Besides natural disasters and geopolitical hotspots, there are other global developments that investors are watching that may dent the market's advance. These include:

- Central banks around the world, including the Federal Reserve, are looking to normalize policy. There is a risk of sustained tightening leading to an economic slowdown if not recession.
- The 19th Congress of the Chinese Communist Party is convening later this month. Current President Xi Jingping may emerge with a more forceful voice once he has secured a new 5-year term. While currently seen as unlikely, a more aggressive Chinese stance may raise the prospect of a trade war which would likely cast a chill on global markets.
- European equity markets have seen a surprising uptick in the wake of the pro-European Union (EU) vote in France earlier this year. The recent referendum in Spain and ongoing negotiations with Britain over their EU exit could cause renewed concerns over the stability of the European Union.
- President Trump has rolled out a blueprint for tax reform and the market has rallied. While its passage would likely help sustain the market's advance, it's fair to imagine that defeat would cause the market to sag.

Currently, global markets are looking past these concerns and rewarding solid corporate earnings, and there's the thought that markets evaluate growth and inflation differently than the Fed.

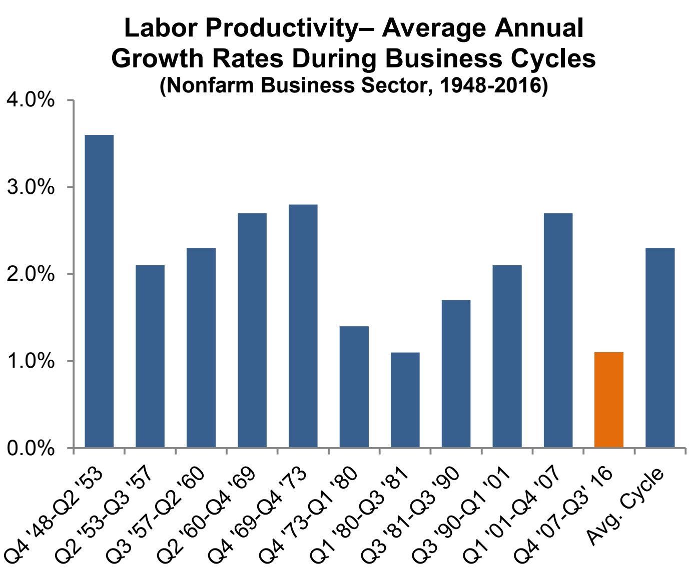
What If?

The Federal Reserve works with data and data collection practices that have been around for decades. Having a solid and steady approach helps give context and a reasonable comparison of today's environment to the past. But what if the environment has changed?

For instance, the original S&P 500 index, a common measure of the U.S. stock market and the broader economy, was launched in 1957. It originally held 425 industrial stocks, 60 utilities and 15 railroads. Financial stocks were added in the 1970's at which point the index included 400 industrials, 40 utilities, 40 financials and 20 transportation stocks.[e] Technology stocks, absent just 40 years ago, now comprise 23% of the index. Even S&P committee member David Blitzer has said of the index, "At the end of the day, it's more an art, not a science."[f]

So the index has evolved as our economy has evolved. It's not a perfect yardstick of the market but it still has its usefulness. Yet when it comes to evaluating inflation, economic growth and productivity, the Fed still uses metrics that have not changed in decades, and have not adapted to our changing economy.

One outcome from these measurement techniques is the conclusion that productivity growth is an anemic 1.1% (chart below). But that feels too low. The pace of innovation seems much higher than that. Hailing a private car with a mobile phone (Uber), booking someone's Manhattan apartment while they're away (Airbnb) or seeing Boeing experiment with 'printing' new parts with 3D printers are all items not captured with traditional economic measuring techniques.



Source: Bloomberg

It's hard to quantify, but if you agree with the premise then the takeaway is that inflation is actually overstated. We are getting far more benefit and utility from the same dollar which is why if The Six Million dollar man were to be built today, it is estimated the technology would cost just $12,000.[g] This suggests interest rates will stay low while profits continue to grow. As we believe that equities are the asset class that benefits the most from human ingenuity, we continue to favor equities over bonds for the long term.

However, we continue to see global risks as currently balanced and have maintained our neutral positioning within our Global Asset Allocation strategies. With our long term preference for equities in mind, we are inclined to add to equities on a pullback.

We hope everyone is able to enjoy the fall season. As always, please feel free to reach out with any questions or thoughts. We want you to feel comfortable with what you own and ensure it fits your long term needs.

Regards,

Richard Sipley, CFA

e. Caplinger, Dan. "3 Facts You Didn't Know About the S&P 500". The Motley Fool, 18, January, 2016.
f. Driebusch, Corrie. "S&P 500 Gets Its First New Sector Since the Dot-Com Era". Wall Street Journal. 16, September, 2016.
g. NPR Planet Money Episode 631, "The Long Run". 10, June, 2015.

Performance of Notable Indices	Q3 2017	YTD (1/1/17 – 9/30/17)
S&P 500 Index	4.5%	14.2%
U.S. Midcap Equities	3.2%	9.4%
U.S. Small Cap Equities	5.7%	10.9%
International Developed Market Equities	5.4%	20.0%
Emerging Market Equities	7.9%	27.8%
U.S. Core Bonds	0.9%	3.1%
Global Bonds	1.7%	6.0%
Gold, $/troy oz	3.1%	11.1%

Total return indices unless otherwise stated. Notable indices shown for illustrative purposes include the S&P 500 Total Return Index, the S&P Midcap 400 Total Return Index (U.S. Midcap Equities), the Russell 2000 Total Return Index (U.S. Smallcap Equities), the MSCI EAFE Total Return Index (International Developed Market Equities), the MSCI Emerging Markets Total Return Index (Emerging Market Equities), the Barclays U.S. Aggregate Total Return Bond Index (U.S. Core Bonds), Gold spot price/troy ounce in U.S. dollars, and the JP Morgan Global Aggregate Total Return Bond Index (International Core Bonds). You cannot invest directly in an index. Data source: Bloomberg.

NOTES AND DISCLOSURES