the Connection

A Quarterly Review 2nd Quarter 2017

TO INVEST OR NOT

According to many articles we have seen in the news recently investors should sell their stocks. The main thesis that the stock market is overpriced. Most of those factors look at stocks in a microcosm, instead of the world as an economic whole.

Let's start with the myriad of reasons why the articles claim you should not own stocks. Reason One - stocks have gone up and up and up. They can't keep going up. Reason Two - stocks in the U.S., in general, have stretched price to earnings valuations. Reason Three - war, famine, Trump, Democrats, healthcare, North Korea. Reason Four - interest rates are going up (and potential inflation), putting pressure on stocks. Reason Five - U.S. companies are overburdened with debt and are at risk of default.

We are not saying that any of these views are necessarily wrong, just giving a counterpoint. Stocks have gone up and up for more than a century. Yet people, and institutions, continue to buy them. Why? Everyone knows that what goes up must come down, so why have investors continued investing for the last 100 plus years? The answer is intuitive, yet not inherently obvious. As long as commerce continues, and business continues, the stock market is perpetual. The utility value of owning a working company in a world that engages in economic transactions is persistent. By persistent we mean the value cannot be zero. The only paradigm shift that can change this is when companies no longer engage in economic activity (also known as government, non-profit, or charity). Stocks will always be a useful means of investing, the allocation to which is determined almost solely by your investment time horizon.

U.S. stocks have stretched valuations. The question is "compared to what?" Interest rates are low, inflation is low. Rising interest rates and/or inflation create valuation problems with fixed income and real estate as well. Let's go back to utility value. Companies are able to pass through higher input prices (inflation) and charge higher end prices, thus increasing profit (fixed income is fixed). Obviously not all companies can do this (as discussed in prior quarters). We are looking for companies that have reflective pricing power for this reason. The stretched valuations (forward P/E of 16-18x for the S&P 500) is high relative to past periods. Those past periods however, especially in the 80's and 90's, had treasury yields for ten year bonds at 6-10%. If it was possible to buy a ten year treasury today and earn 10% we would probably take that over a stock market with a dividend yield of 2%. Unfortunately, we can't, which is the reason why valuations are stretched.

As long as the earnings portion of the P/E rises, then the price part can remain stable or increase. Earnings are rising faster than GDP for a number of factors, not the least of which is because imports are subtracted from GDP, but not from earnings. Earnings growth is projected to be in the high single digits which justifies that P/E ratio that is so stretched.

Idiosyncratic risk – Things like war, politics, and disease. You can be wary of these things but you cannot allow them to impact your investment decisions. There will be wars and political problems. Put the fears aside and invest. Don't let fear keep you from participating in a decade of investment returns.

Interest rates and inflation can impact stock market valuations. As mentioned earlier when talking about high P/E ratios (they really are not that high, look at 1999), interest rates and inflation impact everything. But, interest rates and inflation are signs of a healthy working economy. A healthy working economy favors companies far more than it favors gold, cash, or T-bills. Yes, companies will have to perform well to do well but that has always been the case. That is not specific to this period in time. What is specific, and what has many people spooked, is that we have not had interest rates this low for this long. Janet Yellen, and whomever replaces her, know this. They will be patient and transparent. They are looking at asset prices while they hike rates and they are also cognizant of their inability to control long term rates. The interest rate hikes will stop coming if they impact the economy and by proxy the stock market.

Lastly, the debt burden. A lot of companies went borrowing in the last eight years because money was cheap. That debt burden is going to catch up to companies that over-borrowed but as a whole, the stock market is not terribly indebted. Rates are low, so the debt payments are low. Many of these companies borrowed money in the U.S. instead of repatriating cash from oversees. So instead of paying taxes, they borrow money, and pay the interest expense with money sitting overseas thus not paying tax when the money comes over.

Some people are looking at the debt burden and saying it is onerous across the board to all industries. However, we are looking at specific industries only. The debt burden on some U.S. companies is heavy, specifically ones that are reliant on commodity values for their income like in the Energy and Materials sectors. If you can't control your pricing, and you have too much debt, it doesn't matter what the interest rate is, it's trouble. Certain retailers are also at risk, but the stock

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market as a whole we don't feel is impacted by debt. There have always been boom and bust cycles related to debt. It only becomes systemic when it involves the public. Peoples' balance sheets are healthier than they were last decade, so until we are faced with indebted consumers the stock market will not be impacted.

We have been holding cash and investing slowly for quite some time. We don't make radical changes, or trade that often, and we allow cash to accrue until we find opportunity. We harbor some market skepticism, but just for the short term. The majority of us have an investment time frame that is longer than five years, and when that is the case, having a healthy allocation in stocks is the right place to be.

THE ACT OF GIVING

Below is an updated list of some organizations our clients are helping today.

All Local Food Banks
www.sfmfoodbank.org
www.shfb.org
www.foodbankccs.org
www.refb.org

Bloom Marin
www.bloom.org

Maya's Music Therapy
www.mayasmusic.org

Frien*ds of the Urban Forest*
www.fuf.net

Guide Dogs for *the Blind*
www.guidedogs.com

Doctors *without Borders*
www.doctorswithoutborders.org

The Nature *Conservancy*
www.nature.org

Nationa*l Kidney Foundation*
www.kidney.org

Guide Dogs of America
www.guidedogsofamerica.com

Golden Gate National Parks Conservancy
www.parkconservancy.org

Fine Arts Museums of San Francisco
www.famsf.org

Canine Companions for Independence
www.cci.org

Alzheimer's Association
www.alz.org

The Foundation for Rotary International
www.therotaryfoundation.org

Wildcare
www.wildcarebayarea.org

Homeward Bound of Marin
www.hbofm.org

Whistlestop
www.whistlestop.org

FINCA
www.finca.org

Sonoma Land Trust
www.sonomalandtrust.org

Friends of the Earth
www.foe.org

The American Civil Liberties Union
www.ACLU.org/Donate

The American Friends Service Committee
www.afsc.org

Amnesty International
www.amnestyusa.org

The Friends Committee on Legislation Sacramento
www.fclca.org

Eastside College Prep
www.eastside.org

Northern Sierra Partnership
www.nothernsierrapartnership.org

American Bird Conservancy
www.abcbirds.org

The Cornell Lab of Ornithology
www.birds.cornell.edu

Mono Lake Committee
www.monolake.org

California Trout
www.caltrout.org

Tahoe Rim Trail
www.tahoerimtrail.org

Ocean Conservancy
www.oceanconservancy.org

Global Fund for Women
www.globalfundforwomen.org

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