Observations and Outlook

January 7, 2018

Selected Index Returns 4th Quarter/ Full Year 2017

Dow Jones Industrials 10.96%/ 28.1% S&P 500 6.64%/21.8% MSCI Europe 2.21%/25.51%

Small Cap (Russell 2000) 3.3%/13.65% Emerging Mkts 7.44%/37.28% High Yld Bonds 1.7%/6.22%

US Aggregate Bond .39%/3.54% US Treasury 20+Yr 2.5%/ 9% Bloomberg Commodity 4.71%/1.7%

2017 was interesting in several areas. It was the first time in history the S&P500 had a 'perfect year' where every month showed gains in stock prices. We are also in record territory for the longest length of time without a 5% pullback, almost 2 years. Historically, 5% drawdowns have occurred on average 3-4 times *each year*. In addition to *price records*, there are several *valuation* metrics at or near all-time records. The ‘Buffet Indicator’ (market capitalization to GDP) just hit 1.4, a level not seen since Q4 1999. “Highest ever” records are exceeded well into mature bull markets, not the early stages. Stock markets generally spend most of the time trying to recover to previous highs and far less of the time exceeding them. Momentum and priced-to-perfection expectations regarding tax policy are driving investors to be all-in this market, as reflected by Investors Intelligence Advisors’ (IIA) and American Assoc. of Individual Investors (AAII) stock allocation and sentiment surveys each at 18 and 40-year extremes. Combined with the Rydex Assets Bull/Bear Ratio, at its all-time extreme bullish reading, it’s difficult to argue who else there is to come into the market and buy at these levels.

Wells Fargo Gallup Investor Optimism Index

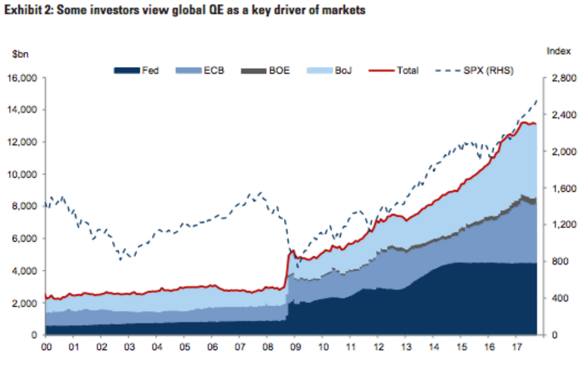
View of the stock market	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
% optimistic	32%	42%	51%	54%	63%	61%	68%	63%
% very optimistic	5%	6%	11%	14%	24%	20%	25%	25%

Source: Wells Fargo, Gallup

Investor optimism is a lagging indicator, it indicates what has happened in markets already. Sentiment indicators show how investors feel now, after stock market gains. Similarly, optimism is very low after market declines. Two important ideas to draw from this are that optimism and stock prices can still grow higher and it may be helpful to recognize the level over multiple market cycles. Investors are as ebullient as they were in 2007and 1999, near market peaks. Extreme valuation and extreme optimism/confidence/bullishness are hallmarks of late stage bull markets—how much higher markets can move is anyone’s guess.

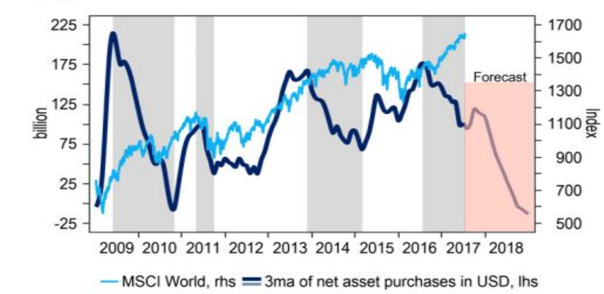
Last year I forecast a choppy market. This proved to be accurate for gold and 20yr Treasury bond prices, which advanced and declined by more than 7% several times, and oil which fell 22% early on, only to rise by 33% into the year end, nearly matching the May 2015 highs. But for equities around the world it was essentially a very large swell. The rise in global equities matches almost perfectly the decline in the US dollar and the rise in Central Bank balance sheets as another $2 trillion in liquidity was added to financial markets. While the US Federal Reserve ceased its bond purchases, Japan, China, and European central banks more than made up for the Feds lack of participation. These are likely to have an impact on asset prices in 2018 as Central Banks have begun to reduce and are scheduled to cease further stimulus in 2018 with full calendar estimates to show a decline in aggregate balance sheets. That is, by the end of 2018 central banks will be reducing, instead of adding, liquidity by the end of the year.

Exhibit 2: Some investors view global QE as a key driver of markets



Source: Haver Analytics, Goldman Sachs Global Investment Research

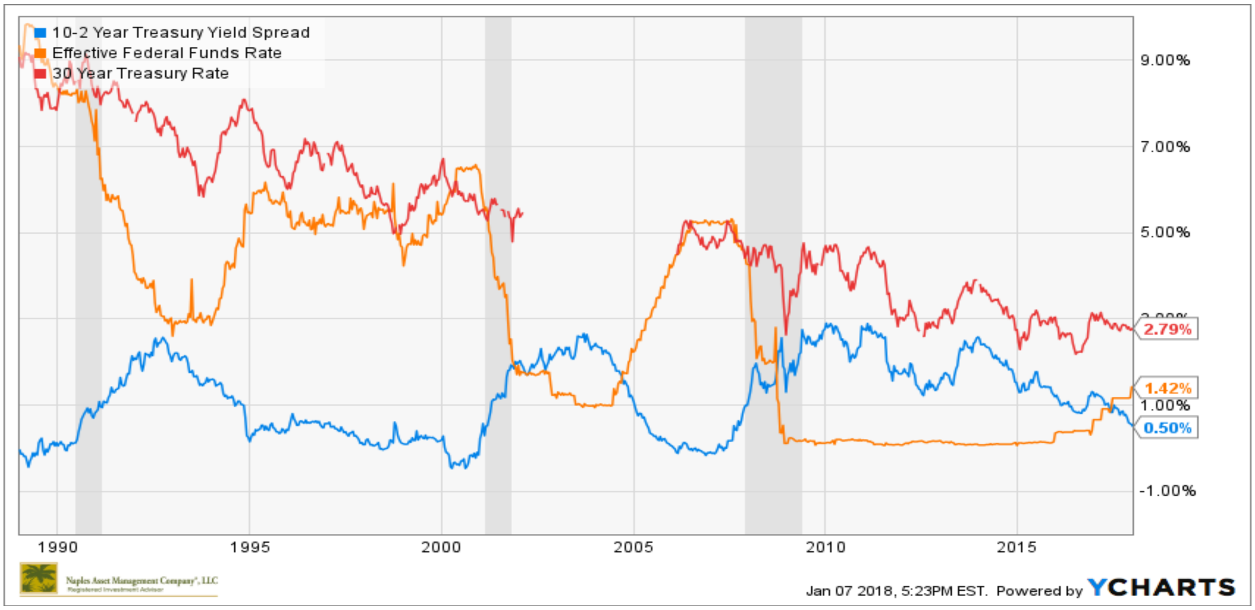
Figure 3. Central Bank Net Asset Purchases (US$ bn) and MSCI World Equity Index, 2009-2018F



Source: MSCI, Macrobond and Citi Research Citi forecast

Higher interest rates and a growing economy tend to increase the value of one currency over another. If this is to be accepted the decline in the US dollar in 2017 can be taken as a pullback from the gains in 2014-2106. At the same time, ex-US equities had a difficult time. Since the dollar's peak in late 2016 the decline has been a strong tailwind for international stocks. At the same time helping multinational companies in the Dow and S&P 500 earnings grow due to favorable exchange rates. 40% of S&P 500 revenues are from outside the US. If the US dollar bottoms our and turns up, it will likely be a headwind to US company earnings and prices of stocks outside the U.S.

After surging post-election, long term interest rates generally fell most of the year (chart below) and continue to be muted. This reflects market participants' doubt that inflation is a concern. Short term rates that the Federal Reserve has a great deal of influence over have risen alongside the Fed's increases in the Fed Funds Rate. Higher short term, and lower long term rates is a yield curve "flattening" and has been a good indicator of a slowing economy--over the next several quarters. It is not a good real-time indicator, but more of a big picture economic indicator, not a stock price indicator. One must also be alert for, I feel, the erroneous intermingling of economic and market indicators. Rates remain range bound and likely will continue as such.

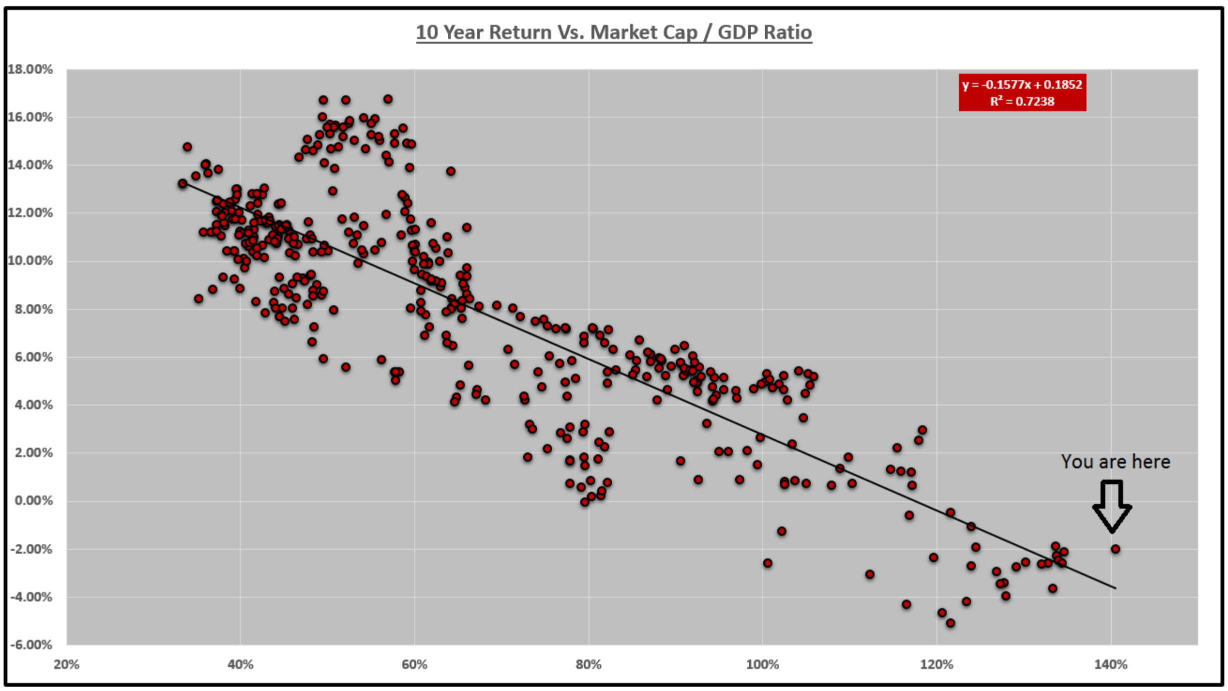


The chart above shows the spread on 10yr vs. 2yr treasury rates. An inversion of this spread, below 0 is a very good indicator of a coming recession. What is most interesting here is that prior to the past 3 recessions, the spread has actually ***increased*** after bottoming out. So, while many are talking about the possibility of going below 0 (which given the extreme low rate environment may not even be possible) investors should be more concerned if the **spread widens**. An initial widening, with long rates going up faster than short rates would likely be greeted as a good thing (yeah! More inflation!) but may be more likely to signal a recession in the very near term.

Sentiment is extremely bullish, and investors are positioned long stocks as much as they have since the dot-com peak. Margin is at record highs and cash levels are at record lows. But there **is no reason these metrics cannot get even more extreme**. Market valuations (not prices) entered the very high range a few years back. Since that time central banks have continued to pour liquidity into global markets, buying stocks, bonds and etfs. As a result of climbing prices, investor optimism has never been higher.

Given the rise in prices has been far faster than the earnings said to support said rise, and the recent nearly 80% annualized rate of price gains over the pas 45 days, its not difficult to argue that stock prices have gotten ahead of themselves. Sustained gains in prices often happen while ‘climbing a wall of worry’. Investors see no such wall or other impediments today. As such, I renew my outlook for stocks to be choppy, likely seeing greater than 5-10%% movements during the year with the biggest question mark for the second half when global liquidity from central banks comes to a stop. Any hiccup in the story of tax-reform-growth, or 'coordinated-global-economic-recovery' is likely to have an outsized negative impact on a stretched market.   Bonds will likely trade rangebound earning investors a few percentage points in interest while gold and oil are likely to see some resistance as they approach multi-quarter highs.

Fortunately, investors will have options and opportunities to earn gains in a variety of asset classes and not rely solely on an over-valued stock market. True diversification comes from recognizing this and implementing a strategy to buy low and sell high, as opposed to buying high and prices going higher. Recognizing an over-valued stretched market is the first step to ***keeping*** the gains one has made, and the second step is having a sell discipline—the strategy to lock in gains and avoid declines. History teaches us that the **forward returns** over the next several years from these high valuations will likely be close to 0, along with an outright bear market in that timeframe.   One can prepare for a decline today or be told in the future, to "ride it out".   Again, history tells us that most will endure the latter.



Adam Waszkowski, CFA
awaszkowski@namcoa.com
239.410.6555

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