

“An Investment in Knowledge Always Pays the Best Interest”
(Ben Franklin)

A Most Excellent Adventure...



Rufus (played by George Carlin): *“Hi, welcome to the future. San Dimas, California, 2688. And I'm telling you, it's great here. The air is clean, the water's clean, even the dirt, it's clean. Bowling averages are way up, mini-golf scores are way down. And we have more excellent water slides than any other planet we communicate with...Don't worry, it'll all make sense. I'm a professional.”*

Ted (played by Keanu Reeves): *Bill, I think they want us to say something.*

Bill (played by Alex Winter): *What should I say?*

Ted: *Make something up.*

Bill: *Be excellent to each other.*

Ted: *Party on, dudes!*

Bill: *Good one, dude.*

“Bill and Ted’s Excellent Adventure” comes to mind as we consider the current state of the markets. We can almost hear the cries of *“Excellent!”* and *“Most Triumphant!”*, along with the accompanying air guitar squeals, as the market closes higher, seemingly every day.

The global economy continues to grow, global manufacturing is solid, corporate earnings are strong, and we already are beginning to see here in the US the potential growth catalyst provided by the year-end tax legislation (bonuses are being paid, hiring is increasing, and capital investments are increasing). We give equal credit to the roll back by Executive Order of a fairly significant list of regulatory and generally anti-business restrictions implemented by the previous administration. American corporate capital is coming off the sidelines.

Donald Trump is a polarizing personality, to say the least. But what he said recently in Davos seems to be true: *“America is Open for Business.”* After Trump was elected, we wrote in a Monthly Commentary about *“Good Donald”* and *“Bad Donald”*. Good Donald and the Republican Congress are helping to unleash the *“animal spirits”* again in the US economy, and though for many other reasons, the global economy overall is illustrating similar growth trends.

But Bad Donald is never very far away. With respect to the economy, this could manifest itself in overly protectionist trade policies, the confusion and contradictions over his dollar policy, massive potential political conflict over immigration, and potential legal challenges or confrontations with respect to the Robert Mueller investigation as we head into a mid-term election cycle.

We don’t believe any of these issues individually can knock the US growth story off course, but collectively they could affect future growth rates. Trying to predict what will happen with or to Donald Trump is a loser’s game that we try very hard not to play – we simply note that his many detractors, whether for political, ideological, social, or personal reasons consistently seem to under-estimate him.

So, what might knock the global growth story off-course? The list consists of the usual suspects: (1) Central Bank policy mistakes (that is, central bankers raising rates too quickly and choking off the expansion *or* not raising them quickly enough and allowing inflation to get ahead of them); (2) political and geo-political events (with North Korea remaining at the top of the list, followed by the ongoing political and legal imbroglio in Washington, DC between the Administration, the FBI, the Justice Department, and Congress); and (3) trade or currency wars.

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The public markets seem very expensive to us, but an expanding economy and strong corporate earnings growth should support a continued rally, at least for a while. There are signs that inflation is heating up, and we believe interest rates will eventually move up, but neither so quickly that the market cannot absorb them.

There are some signals that the market is over-heating, specifically (1) sky high investor sentiment / bullishness; (2) the amount of retail money that is coming off the sidelines and into the market as the “fear of missing out” (“FOMO”) syndrome picks up speed; and (3) the rapidly declining “put/call” ratio – indicating that less and less investors are interested in hedging their portfolios (via buying put options) and more interested in buying leveraged upside potential (via buying call options). All of these are clearly bullish sentiment indicators but, unfortunately, history is pretty clear that excessive bullishness (especially at the retail level) frequently precedes market corrections.

We’ve been pretty right so far on two of our early market calls: (1) Bitcoin crashed; and (2) the Federal Government shut down. We say “pretty” right because (1) while Bitcoin did drop more than 40% in a matter of days, it has (for now) stabilized and is range bound; and (2) the Government did shut down but only for 2-3 days and no one really noticed or was overly affected.

Where we have been decidedly wrong is on the US dollar. We anticipated a stabilization of the dollar as interest rates moved higher, the Fed signaled regular tightening actions, and the US economy heated up. Boy have we been wrong, at least so far. Part of the problem are the completely mixed signals on policy coming out of the Administration – Treasury Secretary Mnuchin broke precedent by stating that the US actually *avored* a weak dollar, only to have that statement walked back by President Trump the next day.

Regardless, if the dollar slide should continue it will be good for exports, non-US investments, and the real asset complex (witness the recent rise in oil prices). But it will make imports more expensive (and we are a net importer on the global trade scene), which may impact inflation rates and partially offset the purchasing power of finally-increasing wages. Long-term, the US does not benefit from an ever-weakening dollar.

With that as a backdrop, looking out over the current economic and investment landscapes, here is what we see.

The Current Economic & Market Landscape

- The global economy remains solidly positive right now:
 - US Q4 GDP came in at 2.6%, lower than the expected 2.9%, but still solidly positive. Thanks to back-to-back second and third quarters’ growth of >3.0% (offsetting the Q1 growth rate of 1.2%), the overall GDP for 2017 is estimated at 2.5%. The consensus estimate for GDP growth in 2018 is 2.8%, but there are many factors that can affect this (either positively or negatively). The consensus estimate of the risk of recession, however, remains low at only 15% (source: *The Wall Street Journal*);
 - Both the US manufacturing and services sectors remain well in expansionary mode – the ISM manufacturing index came in at 59.7 in December (up from 58.2 in November), and the non-manufacturing index came in at 55.9 (down from 57.4 in November); anything above 50 is considered expansionary;
 - Inflation remains a question mark but may be beginning to show itself – both the “headline” and “core” (which excludes the volatile food and energy sectors) inflation numbers are hovering around the Fed target of 2% YoY, but there are some signals that inflationary pressures are beginning to work their way through the markets, mostly on the wage side. Should the slide in the dollar continue, we may see an increase in commodity and import prices, which may exert upward pressure on inflation. In response, the Fed seems to remain committed to raising rates 3-4 times in 2018;

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- With roughly 90 S&P 500 companies having reported so far in Q4, corporate earnings are up 8.6% YoY, on steadily improving revenues. When the earnings season is over, the estimate is for a 10.8% increase in earnings on a 7.3% increase in revenue (source: *Zachs Earnings Report*).
- There will be some one-time distortions to earnings due to the changing tax landscape, but the net result of those tax changes are expected to be positive as corporations announce increases in expansion, capital investment, and hiring. We are especially pleased with the upward trending capital investment spending (it was the primary driver of the solid Q4 GDP number);
- The Eurozone Q4 2017 GDP growth rate consensus estimate is 2.4%, and 2.0% for all of 2018 – low by historical standards but very solid given Europe’s troubles in the aftermath of the financial collapse of 2008 (source: *TradingEconomics*);
 - GDP and manufacturing are expanding across the Eurozone, with the Markit manufacturing index falling slightly to 59.6 in January 2018 (after hitting an all-time high of 60.6 in early December 2017 (anything above 50 is expansionary));
 - Unemployment fell to 8.7% in November 2017, a 9-year low, and annualized inflation through December came in at 1.4 % (down from 1.5% in November). New hires are at a 17-year high;
 - ECB Mario Draghi wants to taper his quantitative easing program, but remains frustrated by low inflation rates and a strengthening euro (or, perhaps more accurately, the continued weakness of the US dollar);
- Japan’s Q3 GDP was a positive 2.6% (annualized), and represented the seventh straight quarter of positive GDP growth. The consensus estimate for Q4 GDP growth is 2.4% (source: *TradingEconomics*);
- China’s (official) growth rate for Q4 was again stable at 6.8%, slightly lower than (official) estimates. Estimates are that the Chinese economy will slow slightly in 2018, down to 6.4 – 6.5%, and the Chinese government is stepping in to slow down the recent appreciation of the yuan against the US dollar (source: *TradingEconomics*).

The Towerpoint Wealth Economic & Market Outlook:

- *The global economy is growing, and the probability of recession remains low;*
- *Manufacturing in particular remains expansionary in most major regions of the world; In response to a growing global economy and a weakening US dollar, oil and commodity prices have risen or stabilized over the past 2-3 months, this may continue if the dollar continues its slide;*
- *Inflation remains troubling, though some analysts believe that there are “hidden” inflationary pressures (specifically with respect to now accelerating wage growth and potential price pressure from a weak dollar);*
- *The primary risks to an otherwise positive economic outlook are (1) geo-political events (specifically North Korea); (2) US policy initiatives (or responses) that trigger a global trade or currency war; (3) that the Fed acts too soon in raising rates and chokes off the expansion; and (4) changing investor sentiment as the markets continue to run and/or there is an exogenous legal or political event that “spooks” investor confidence;*
- *The consensus view remains that, barring unforeseen events, the Fed will seek to raise rates 3-4 times in 2018;*
- *The recently passed tax law changes are already impacting market prices and corporate activity, and should act as at least a short-term stimulus to further economic and earnings growth;*
- *Solid GDP, earnings, and revenue growth, combined with low (but rising) rates and low (but rising) volatility, make for a very positive environment likely to continue through at least the first half of 2018, but equities still look expensive to us;*
- *EM and EAFE markets continue to have better valuations than the US (though they are by no means cheap). The USD trend is the wild card for US investors – should the recent slide continue, it will provide a nice currency tailwind to non-US returns for US investors;*
- *The US yield curve remains flattish but we do not anticipate an inversion – we do expect rates to begin to rise later this year, a view which could be catalyzed by an uptick in inflation, estimated economic growth rates, or a*

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tapering of the ECB QE program (which may narrow the yield differential between European and US sovereign debt);

- *At these rates and credit spreads, the public credit markets look very expensive to us, though coupons are probably safe as corporate balance sheets are in good shape. Several of the “opportunistic credit” managers we follow have begun to “de-risk” their portfolios in anticipation of rates and/or spreads widening back out from current levels;*
- *For investors who can access the private markets and handle some degree of illiquidity, we still believe there are better opportunities in the private markets versus the public markets, even in the face of compressed premiums versus historical levels, driven by huge investment flows over the past 18-24 months;*
- *As was true in 2017, we believe 2018 should continue to be constructive for alternative investments. We continue to believe that hedge funds generally will deliver superior performance than their liquid alternative brethren, because of less liquidity and leverage constraints;*
- *Increased volatility and increased dispersion between individual security prices should result in better opportunities for active management.*
- *Global commodity supply continues to exceed demand, but a falling dollar, should it continue, will benefit the real asset complex;*
- *While we generally are constructive on the global economy and overall market performance, the public markets are not cheap, even taking into account the potential benefits of the US tax law changes. While we see little reason why the current market rally cannot continue, we also believe that clients need to have their expectations managed as to what a globally diversified portfolio can deliver over a full market cycle.*

2018 is starting out as a continuation of the “most excellent adventure” we enjoyed for most of 2017. We continue to see many good and positive things – a growing economy, very solid earnings, and the emerging potential benefits of the tax legislation passed in the US at the end of the year. The weakening dollar has us a little puzzled, though it will be positive for the non-US investments and the real asset complex if it continues, and increased volatility should benefit our alternative investment strategies. We think inflation will increase with growing wages and generally rising interest rates.

But until and unless economic and market conditions change more than expected, or there are exogenous events that change investor sentiment, we believe we can continue to “party on” and “be excellent to each other”.

Warm Regards,



Joseph F. Eschleman, CIMA®

President

Towerpoint Wealth, LLC

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