

## ***All is for the Best in the Best of all Possible Worlds***

Goldilocks is going back for thirds. The beneficent global economic regime we've described for the past several months remains solidly in place – global economic growth (especially in manufacturing), strong corporate earnings and revenues, raging equity markets, low interest rates, and an almost frightening level of market complacency.

It seems increasingly probable that Congress will pass some level of tax reform in late 2017 or early 2018, and that will provide a further catalyst to economic growth. Even if the legislation is somewhat pork-flavored and, at the same time, watered down, it should still be stimulative to further economic expansion.

Likewise, the appointment of Jerome Powell seems to be making the markets very happy, given what seems to be his inclination toward following the Janet Yellen slow and steady approach to raising interest rates.

Both wages and inflation are rising, which is positive, and makes the Fed's decision to raise rates in December a near certainty. Oil prices seemed to have stabilized as well, so while inflation remains somewhat muted given the overall levels of economic growth and low unemployment, the pieces seem to be in place for a future increase in inflation.

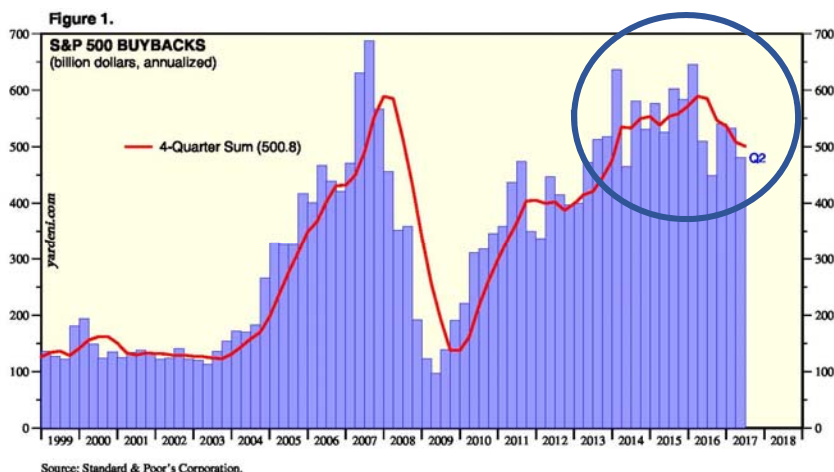
The wild cards are as follows: (1) The Fed raising rates in the face of presumptive but no explicit inflationary pressure – will it put the brakes on the expanding economy?; (2) Fiscal stimulus by way of tax reform injected into an already expanding economy – this seems to put fiscal policy and monetary policy into somewhat of a “push-me / pull-you” situation; and (3) exogenous geopolitical events, specifically North Korea. It's hard to decipher the actions of a madman, and no one should believe they know absolutely what will happen, since anything could, up to and including military conflict. Uncertainty ensues.

Let us insert a famous literary reference, the opening sentence of Charles Dickens' *“Tale of Two Cities”* (emphasis added):

*“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.”*

The following graph illustrates the point.

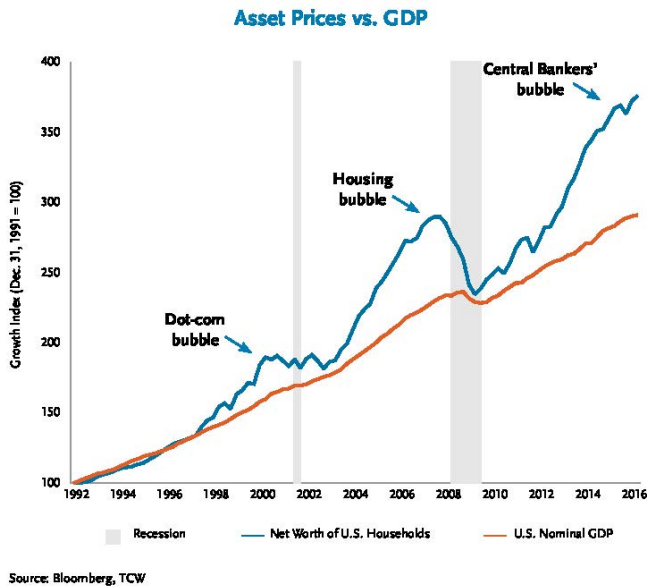
1. It was the best of times:



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For the past several years, the market delivered increased earnings in the face of flat to moderate revenue growth, primarily by way of financial engineering – stock buy backs and increased dividend payouts. While a completely legitimate method of enhancing current shareholder value, it is unsustainable. At some point, companies need to grow top line revenue and re-invest back into internal R&D, capital expenditures, and hiring. What the graphs above suggest is that this is beginning to happen. In the face of increased revenues and earnings, financial engineering is abating. We view this as a very positive signal to further expansion.

2. It was the worst of times, borrowed from our favorite game theorist Dr. Ben Hunt's Epsilon Theory, who in turn borrowed it from asset manager TCW:



The magnitude of the effect of global quantitative easing on stock prices simply cannot be dismissed or underestimated. As the US begins an attempt to “normalize” rates and the ECB seems not too far behind, no one should delude themselves (yet again) that, “*This time it’s different.*”

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 Q3 GDP came in at 3.3%; GDP growth estimates for all of 2017 are now at 2.5% (*source: The Wall Street Journal*);
  - Both the US manufacturing and services sectors remain well in expansionary mode – the ISM manufacturing index came in at 57.8 in October, and non-manufacturing came in at 60.1 (anything above 50 is considered expansionary);
  - Inflation remains a question mark – both the “headline” and “core” (which excludes the volatile food and energy sectors) inflation numbers are hovering around 2% YoY (the Fed target). The culprits of this low inflation seem to be:
    - Wage growth – wages are increasing, but not at a pace commensurate with the tightening labor markets, though they seem to be accelerating;
    - Ongoing automation and globalization; and

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- Fairly low and stable energy and commodity prices.
- It is hard to see what might change this dynamic over the medium term;
- S&P 500 companies delivered a 6.6% increase in earnings versus Q3 of last year, on a 6% increase in revenues. Firms reported a 72.3% earnings “beat rate” and a 66.5% revenue “beat rate” – both higher than multi-year averages (source: *Zachs Earnings Report*);
- The Eurozone Q3 2017 GDP growth came in at 2.5% (annualized); the consensus estimate for Q4 is 2.4% (source: *TradingEconomics*)
  - GDP and manufacturing are expanding across the Eurozone, with the Markit manufacturing index hitting 57.5 in October (anything above 50 is expansionary)
  - Unemployment has fallen to 8.9%, an 8-year low, and annualized inflation through October was 1.4%. New hires are at a 17-year high;
  - ECB President Draghi announced a “tapering” of quantitative easing, but market interpreted his comments as dovish and “lower for longer”;
- 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 Q3 was again stable at 6.8%, and (official) estimates for Q4 are 7.0% (source: *TradingEconomics*).

### **The Towerpoint Wealth Economic & Market Outlook**

- The global macro-economic environment remains benign;
- Global inflation remains low – this creates some level of uncertainty regarding central bank policies;
- Increasing probability of tax reform in the US – maybe a “watered down” version in late 2017 or early 2018, but Trump’s agenda (ex-Executive Order) is struggling in the face of universal resistance by Democrats and a handful of recalcitrant Republicans;
- Solid GDP, earnings, and revenue growth, combined with low rates and low volatility, make for a “Goldilocks” environment likely to continue for some time, but equities still look very expensive to us;
- EM and EAFE markets continue to have better valuations than the US (though not cheap). The USD trend is the wild card for US investors – we think the year-long slide is ending;
- The US yield curve remains flat but we do not anticipate an inversion – lower for longer and slowly grind higher remains the name of the song;
- At these rates and credit spreads, the public credit markets look very expensive to us;
- For investors who can access them and handle the relative illiquidity, we continue to believe better opportunities lie in the private markets, even though historical spreads to the public markets have compressed due to massive inflows;
- As we anticipated, it is shaping up to be a better year for alternative investments, but we are more optimistic about hedge funds than liquid alternatives because of less liquidity and leverage constraints;
- We perhaps will enjoy a modest rebound in commodities and oil prices as global economic growth expands;
- While we generally are constructive on the global economy and overall market performance, the public markets are not cheap. Clients need to have their expectations managed as to what a diversified portfolio can deliver over a full market cycle.

So, as we review the economic and market landscape, we see many good and positive things – a growing economy, solid earnings, low inflation, and low interest rates. We assign a fairly low probability to that regime

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not continuing for some time. However, it is important to remember that, while we seem now to be living in the “best of all possible worlds”, we still must *tend to our garden*.

Warm Regards,



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President

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