RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

SECOND QUARTER 2017 MARKET COMMENTARY
July 2017

STATE OF THE MARKETS

The US. equity markets continued to grind higher in the second quarter, with the S&P 500 returning about 8.3% for the first six months of the year and about 15% for the trailing twelve months, with much of the recent overall market return coming from growth stocks. The RDM Capital equity composite, which is heavily value oriented, was up about 13.5% for the trailing twelve months. As described below, we are exercising an abundance of caution by maintaining healthy cash balances in client accounts due to the current fully valued equity markets.

We plan to maintain our caution with investing available funds unless there is a significant market pullback, as the S&P 500 is within the 2,400-2,500 range we projected at the beginning of the year. For most of our clients with equity portfolios, we have raised an average cash position of about 10%-15%, depending on our understanding of the clients' risk tolerance and time horizon. While we do not anticipate adding to our equity positions on a wholesale basis, we will continue to look for company-specific events that may provide opportunities, such as a temporary decline in a company we favor or if there is the potential for M&A to unlock value. For income investors, we will continue to focus on adding preferred stock, utilities and high-grade corporate bonds, as we have done throughout this year.

In this market letter, we will address some of the reasoning for our current investment strategy, focusing on (i) the labor market, inflation and what these factors suggests about the strength of the U.S. economy; (ii) our continued belief in value investing, despite the recent popularity of growth stocks; and (iii) recent company-specific events that have impacted some of our core holdings and favored sectors.

The Labor Market and Inflation

Despite a surge in investor optimism earlier this year, the U.S. economy remains in the slow growth, low inflationary environment that has prevailed for much of the decade. Inflation is still below the Fed's 2% target and U.S. GDP growth remains at roughly 2%. Nevertheless, the Fed raised the Fed Funds rate by 25 basis points this quarter, as it previously telegraphed. The Fed believes inflation is subdued due to temporary, one-off events (like competition among cellphone providers), and signaled that it may raise rates again this year. However, the bond markets increasingly doubt that another rate increase this year is necessary, putting the odds of an increase at slightly less than 50%.

Like the bond market, we also are cautious about the Fed's view on inflation and whether the economy needs additional rate hikes in the near-term. One of the most perplexing economic questions in recent years has been why wage growth and inflation remain low, despite the economy being close to full employment. Low unemployment can lead to higher wage pressure and ultimately higher inflation in the short-term as more people go to work and workers have more money to spend. However, while the U-3 unemployment rate (which includes only those actively looking for work) is at 4.3%, the lowest in 16 years, we have yet to see significantly higher wage growth or inflation. There is no doubt that the financial crisis ten years ago led some to leave the workforce and not return, which is not reflected in the U-3 rate. But, the ratio of 25-to-54 year olds who are employed remains around 78%, which is only 2% lower than the percentage prior to the financial crisis. The U-6 rate, which includes unemployed, underemployed and discouraged workers, also is near its pre-recession level at 8.4%.

We believe that the inability of the economy to break out of its low inflation, low growth pattern is the result of a combination of secular and variable factors that largely are beyond the Fed's control. On the secular side, the aging of the Baby Boomer generation and the increasing rate of technological advancement tend to be deflationary. As more workers age and leave the workforce, wage and productivity growth decline as experienced workers are replaced by younger workers who initially make less money and are less productive. Technology also can have a deflationary impact, as it can lead to declining consumer good prices while also making certain jobs obsolete. We believe pro-growth fiscal policy and additional skills training for displaced or underemployed workers can at least partially mitigate the impact of these secular forces. But, the Fed cannot stimulate the economy from a fiscal perspective or train workers whose skills are no longer current. In any event, with the economy and inflation far from overheating, we question whether additional rate increases this year are necessary.

While the Fed is now pushing short-term rates higher, long-term rates remain flat. As a result, the yield curve (i.e., the difference between the two year and ten year Treasury notes) has continued to narrow, down to 0.8% at the end of the second quarter. Before recessions in 2007, 2000, 1991 and 1981, the Treasury yield curve inverted, with short-term rates higher than long-term rates. However, we do not view the current narrowing of the yield curve as a sign that a recession is imminent. Much of the pressure on long-term rates results from the monetary policies of other countries, which now have rates even lower than those in the U.S. This leads international investors to buy U.S. long-term debt, suppressing our long-term yields. Still, we are watching the bond market and the narrowing yield curve for additional signs of a slowing economy.

As a result of our caution about the U.S. economy as a whole, we have been cautious in deploying cash this year. Many of our accounts have more cash than normal, as a result of our current investment strategy decision. We would like to see further clarification on how aggressively the Fed plans to tighten market conditions before significantly adding to our positions. At the same time, we do not plan to add more cash than our current position of 10%-15%, as we do not believe a recession is imminent in the next year. Corporate earnings are strong but not topped out, interest rates are rising but still low, the labor market is near full employment but not overheating, and stock valuations are high but not excessive – all conditions that suggest we are in a mature bull market but still have room to run.

Value vs. Growth Investing in the Current Environment

Some of our clients have asked us why we have not invested in the high-growth stocks that are frequently discussed on CNBC and other financial news talking heads. The simple answer is that we continue to believe our value strategy is best for our clients over the long-term.

In a low growth, low interest rate environment, value strategies (such as ours) have historically underperformed the overall market over short time periods. The reason is that growth stocks tend to beat value stocks when the economy is slow (because investors will pay a premium for future, speculative growth) and when interest rates are low (because less mature, growth-oriented companies have access to cheap capital). Not surprisingly, our value strategy outperformed towards the end of 2016 when investors became optimistic that growth and interest rates would increase. Now that those prospects have become subdued, growth stocks have regained the lead, accounting for a large percentage of the S&P 500 performance.

Nevertheless, we remain fundamental, value investors despite the pressure to beat the market over short-term periods by chasing the latest popular growth stocks. This resolve is based on a few core principles:

- we fundamentally believe in the strength of the U.S. financial system to outperform other countries over time;

- the best way to invest in the U.S. economy is through investing in blue-chip companies with long-term earnings growth histories trading at relatively low valuations – i.e., value stocks;
- companies that are transparent and easy to understand are better investments than more opaque companies with speculative value propositions;
- over the past 55 years, large-cap value has outperformed large-cap growth in all rising interest rate periods (as we are entering now) by an average of almost 7%, while underperforming large-cap growth by only 2.4% in all falling rate periods; and
- over the past 90 years, value stocks have outperformed growth stocks almost 60% of the time, with a return of 17% for value stocks versus 12% for growth stocks.

In short, we believe our contrarian value strategy will outperform over long time periods as it has in the past. We do not currently anticipate any major changes to our strategy despite value's current underperformance versus growth. With valuations for growth stocks increasingly getting stretched, we anticipate another rotation to value stocks in the near future.

Market Developments Impacting Our Core Holdings and Favored Sectors

We'd like to briefly touch on news impacting some of our core holdings and favored sectors.

- General Electric has been a core holding for many years, but we have grown impatient with the company's slow pace of change and earnings growth. Despite recent efforts to simplify its sprawling operations (most notably, spinning-off its financing unit), earnings growth has eluded the company, with CEO Jeff Immelt recently stating that GE is unlikely to meet its $2 earnings estimate this year. After 16 years as CEO, Immelt is retiring and will be replaced by John Flannery, the CEO of GE Healthcare. We are cautiously optimistic that the new CEO will hasten GE's transition from a sprawling conglomerate to a more streamlined power solutions and industrial company. In addition, the presence of activist investors as GE shareholders lead us to believe that sooner rather than later a major shareholder-friendly restructuring of the company will take place.

- Two of our top positions are Microsoft and Apple. Both companies' stock prices fell during the brief pullback in June that hit some high-flying growth stocks. We believe this pullback was unwarranted for Microsoft and Apple (although long overdue for some of the other tech companies). Both Microsoft and Apple were historically growth-oriented stocks, but in recent years have become mature blue-chip stocks. For example, Apple trades at only about 11x earnings when you exclude the significant amount of cash on its balance sheet. Microsoft trades at a higher P/E of about 30x but this is a fraction of the valuation for other tech/internet stocks. Both companies also pay a 1-2% dividend yield. We continue to like their combination of reasonable valuations with growth potential and will look for opportunities to add to these positions as appropriate.

- Energy stocks have continued to underperform the market – the energy sector is down more than 13% this year, dragging down value strategies with it. As we've discussed in prior market letters, oil prices have struggled to find a balance despite OPEC's supply cuts, as U.S. shale producers have ramped up production. While the balancing of the oil market has taken longer than expected, we still believe that the decline in new oil projects begun two years ago eventually will lead to a supply reduction and a much higher equilibrium price than today. Today's price in the high $40's is far below the level of just a few years ago, but still is sufficient for the companies we favor to be profitable. As mentioned above, we believe there are values in this sector for companies that are not excessively leveraged to oil prices and may add to these positions in the second half of 2017.

- Finally, all the banks subject to the Fed's annual stress test passed this year and most have significantly increased their dividends and share buybacks. The major banks that we favor have significant capital positions that make them more resilient to economic downturns than a decade ago. The banking industry strength should further benefit value over growth given that financials comprise a larger portion of value portfolios than growth portfolios. Due to the renewed strength of the major banks' balance sheets, we continue to favor their common stock, as well as their preferred stock for income investors.

As usual, we value and appreciate any comments you might have.

Very Truly,

RDM Capital Associates, Inc.