The Water Valley Review

Water Valley Investment Advisors, Inc. **Third Quarter 2017**

Investment Commentary - Despite its reputation as the worst seasonal period for stocks, global stock markets rallied again in the third quarter. Emerging-market stocks were strongest, surging 8%, followed by European stocks, which gained 6.2%. More broadly, developed international stocks rose 5.5%. For the third consecutive quarter, the U.S. dollar depreciated against foreign currencies, boosting dollar-based investor returns in these markets. The U.S. market delivered strong returns in the third quarter, extending its winning streak to eight consecutive quarters and a remarkable 18 out of the last 19 quarters. The U.S. market closed at an all-time high, gaining 4.5%. **One indicator of how calm the stock market has been this year, despite all the geo-political uncertainty, is that its largest decline has been a loss of 2.8% (from March 1 to April 13). Going back to 1929, there has been only *one* calendar year when the largest drawdown was smaller than that** (Ned Davis Research). Moving to the fixed-income markets, bonds inched up 0.7% for the quarter. The 10-year Treasury yield ended the quarter flat.

Macro Economic and Market Backdrop - The synchronized global economic recovery that we wrote about in the first quarter continues apace, providing a solid foundation for corporate earnings and financial assets in general. Below we highlight a few of the positive global economic indicators:

- The OECD Composite Leading Indicator recently hit its highest level since October 2014.
- The Global Manufacturing Purchasing Managers Index (PMI) hit its highest level in six years.
- Easing inflationary pressures have allowed numerous central banks to lower interest rates, as global central bank policy remains accommodative and stimulative.
- Real GDP growth in the U.S. remains subpar but continues to grind along at around a 2% rate.
- Financial conditions have eased over the past year, despite the Federal Reserve's three rate hikes; this could bode well for economic growth over the next few quarters at least.

Despite the U.S. economy's rather healthy economic indicators, it's worth noting that a typical 5% to 10%-plus stock market correction can happen at any time. **Historically, the U.S. market has dropped at least 5% roughly three times a year and declined 10% or more about once a year. We are at 330 days and counting since the last 5% drop; this is the longest such streak in 26 years.** Given that historical reference, the U.S. market seems long overdue for a correction. However, a true bear market in U.S. stocks (a sustained 20%-plus decline) is almost always associated with an economic recession. Absent a recession, a bear market is unlikely. Recessions, in turn, are typically caused by excessive Fed tightening, an overheating economy, or financial market excesses, none of which *seem* imminent in the U.S. or global economy. **So although this is now the third-longest economic expansion and second-longest bull market in U.S. history, neither appears ready to die of old age just yet.**

Asset Class Outlook - ***U.S. Stocks:*** As noted earlier, the near-term macroeconomic backdrop for U.S. stocks still looks pretty solid. But U.S. stocks have high valuation risk. Across almost every absolute valuation metric, U.S. stocks look relatively expensive. In our assessment, this argues for some caution when it comes to U.S. stocks, looking out over the next several years. That is why we remain modestly underweight to U.S. stocks, despite what may continue to be a supportive macro backdrop for them over at least the next few quarters. ***Foreign Stocks:*** International and emerging-market stocks have generated strong relative and absolute performance over the past year. Part of this performance can be explained by the euro's sharp 12% appreciation against the U.S. dollar in 2017. Consequently, the euro is only slightly undervalued. However, based on our analysis, foreign stocks still look attractive relative to U.S. stocks, and offer solid absolute return potential and why we remain overweight to European and emerging-market stocks. The relative strength chart to the right shows that U.S. stocks' large return advantage since the financial crisis has only begun to reverse. **Financial market history demonstrates, asset classes go through cycles of relative performance—driven not just by their underlying economic fundamentals but by human herd behavior and market sentiment that swing to excess.** We may be in the early stages of the pendulum swinging back in favor of foreign stocks. ***Fixed-Income:*** Within the fixed-income portion of our balanced portfolios, our long-established positions in flexible and absolute-return-oriented bonds, in place of roughly half of our strategic core bond exposure, added value again for the quarter. We continue to believe this strategy provides competitive yields in a low rate environment, while adding protection to a potential rise in interest rates. ***Alternative Strategies:*** Our alternatives investments—including arbitrage, managed futures, real estate, and non-agency mortgage-backed securities—posted positive returns for the quarter. These diversifying positions continue to offer asset protection, with reasonable return expectations.

*Source: Morningstar. Data as of 8/31/17. *International stocks represented by the MSCI World ex USA Index from 1970 to 1988 and by the MSCI ACWI ex USA Index from 1988 onward. The MSCI ACWI ex USA Index includes emerging markets.*

Closing Comments – It is important to remember that the next bear market will surely create some table-pounding tactical investment opportunities, as many risky asset classes will get excessively beaten down in price relative to their longer-term fundamentals. Given our positioning in lower-risk asset classes, we expect to be able to take advantage of such opportunities. **In the meantime, we have built diversified portfolios with multiple strategies that are resilient across a range of scenarios. Our client's portfolios should participate well if this bull market continues, while also providing added protection and opportunity when the market hits a rough spot.** As always, there are significant uncertainties and "unknowables" when it comes to economic and market forecasting. Humility and intellectual honesty—knowing what you don't know and what you *can't know* and can't accurately predict—are crucial. As such, we always consider a range of potential scenarios in our investment decisions and portfolio management rather than betting heavily on any single macro forecast. As the proverb goes, "It's difficult to make predictions, especially about the future." Thank you for your continued confidence and trust. Please find the following economic commentary and forecast from our advisory board member, Dr. Ray Perryman.

The Water Valley Investment Team

Outlook for the US Economy – 3rd Quarter 2017

By M. Ray Perryman, PhD, CEO and President - The Perryman Group

***Employment* - Over the past year, the US economy has generated nearly 1.8 million net new jobs, according to the US Bureau of Labor Statistics (BLS).** Professional and business services gained 528,000 positions from September 2016 to September 2017, while education and health services rose by 472,000. Other notable increases were seen in leisure and hospitality (up 189,000), construction (184,000), financial activities (149,000), and manufacturing (117,000). The information segment saw a decline in employment of -79,000 over the year, and retail trade dropped -78,400. **In September, the US unemployment rate dropped to 4.2%, down from 4.9% one year prior.**

***Impact of Hurricanes* –** Hurricanes Harvey and Irma are likely the cause of the slight drop in US employment in September, and damages caused by the storms will continue to negatively affect the US economy. **Damages are only a part of the economic implications of these storms.** Any economic stimulus, whether positive or negative, leads to additional responses and multiple rounds of business activity. **Business operations have been interrupted, causing lost revenue and profits even beyond the damage to facilities. In many cases, these revenues cannot be recouped.**

Productivity has also been affected as workers are either absent due to problems with their homes and property or less effective on the job as they deal with those issues. **On the other hand, the act of repairing buildings and infrastructure damaged by wind and water leads to an increase in spending in the construction sector.** Suppliers of the goods and services needed to get things back to normal will see additional opportunities due to the storms. Replacing personal items, vehicles, furniture, and everything else will increase retail activity. **These benefits partially offset the overall losses.**

Recovery is underway, and a full recovery for the economies of both Texas and Florida over time, though the human costs and emotional toll of these massive storms will remain with us much longer. **Hurricane Maria, which hit Puerto Rico in September, will also negatively affect the US economy, and the combined impact of Hurricanes Harvey, Irma, and Maria on the US economy over the next several years is estimated to be a $299.8 billion reduction in real gross domestic product, $198.4 billion in lost real personal income, and a loss of 2.1 million job years of employment.**

***Monetary Policy* - The Federal Reserve will begin to reduce its nearly $4.5 trillion balance sheet this month, starting the process of reducing assets purchased during the global**

financial crisis and later quantitative easing (QE) to help the US economy recover from the "Great Recession." The goal is to gradually change monetary policy in hopes that the economy continues to expand and hiring is encouraged, since maximum employment is one of the Fed's statutory mandates. However, the other component of the Fed's role is to keep inflation in check, and an overheated economy can cause price escalation. The Federal Open Market Committee (FMOC) has been carefully watching the economy to determine when to take the next step, balancing labor market conditions and business activity with signs of inflation.

On September 20, the FOMC announced that, in October, the process of balance sheet normalization will begin. **In announcing the decision, the Fed pointed to continuing strengthening in the labor market, rising economic activity, improving business investment, and expanding household spending.** Also, the fact that inflation remains below the target rate of 2% was noted. While the devastation of Hurricanes Harvey, Irma, and Maria has caused severe hardship, storm-related disruptions and rebuilding are viewed as unlikely to materially alter the course of the national economy over the medium term, although conditions will be monitored closely.

***US Key Economic Indicators* -** The Perryman Group's latest forecast for the US economy calls for growth in real gross product of 2.40% through this year, with 2.81% expansion over the 2017-2018 period. Employment is projected to increase at a 1.53% pace, with a 1.66% gain next year.

Indicator	2016-2017 Percent Change	2017-2018 Percent Change
Real Gross Product	2.40%	2.81%
Real Personal Income (by place of residence)	1.67%	2.25%
Total Employment	1.53%	1.66%
Population	0.67%	0.69%
Consumer Price Index	1.73%	1.57%
Industrial Production Index	1.57%	2.58%

Indicator	Percentage Level 2017	Percentage Level 2018
3 Month T-Bill	0.91%	1.51%
20 Year T-Bond	2.79%	3.17%

Dr. M. Ray Perryman is President and Chief Executive Officer of The Perryman Group (www.perrymangroup.com). He also serves as Institute Distinguished Professor of Economic Theory and Method at the International Institute for Advanced Studies.