The Water Valley Review

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

Investment Commentary - As we look back over the first half of the year, a few things stand out. Overall stock market volatility remains extremely low. **The U.S. stock market's volatility recently fell to near its lowest level in the past *fifty* years, while continuing to hit all-time highs.** Also, both risky assets (stocks) and defensive assets (bonds) performed very well. U.S. stocks have returned a solid +9.3%, while bonds have returned a respectable +2.3%. Foreign stocks have been the best performer returning +14.1%, marking a reversal of a mult-year trend of underperformance.

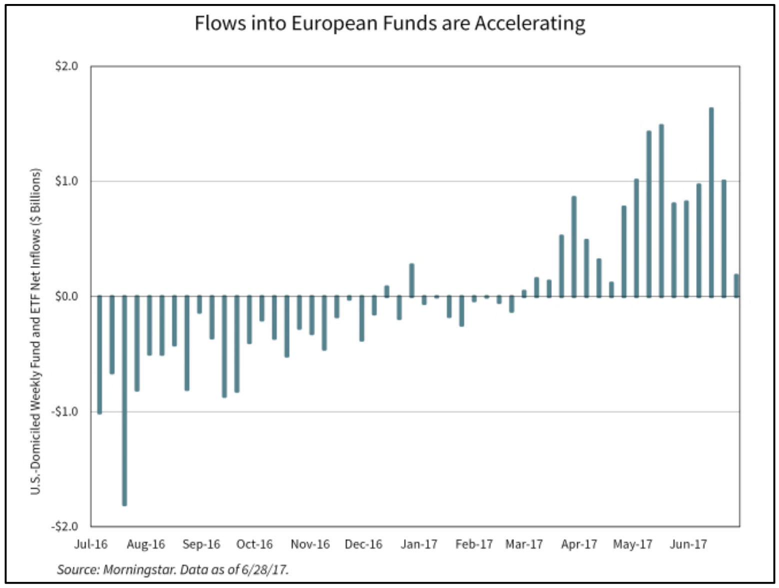
It may seem somewhat surprising or contradictory that both global stocks and defensive core bonds have performed well. Rather than fears of an impending macro shock, it seems the bond market is responding largely to the recent declines in inflation expectations. The equity market, on the other hand, likes neither too little inflation nor too much. So stock investors have had a number of reasons to propel prices higher: Inflation is lower but still in the ballpark of the Federal Reserve's 2% target. The global economic recovery is ongoing. Corporate earnings are rebounding. And global central banks, including the Fed, are not expected to aggressively tighten monetary policy any time soon. **In the short term, both markets may be "right." But the current state is not sustainable for very long—something has to give.** The Fed holds a big key as to how things might play out: will it tighten too much, too little, or manage it just right? Nobody knows, but based on history, we wouldn't put all our chips on any single scenario. Potential changes to fiscal, tax, and regulatory policies are also big unknowns.

Current Trends - Several of the market trends and consensus market views we highlighted at the start of the year have reversed (again) - European stocks are beating U.S. stocks by a wide margin; the U.S. dollar is down (about 6%); Treasury yields are down; oil prices have plunged 20% from their recent highs; growth stock indexes are crushing value indexes; larger caps are beating smaller caps; emerging-market stocks are outperforming U.S. stocks. The recent market shifts only reinforce the point we made then. **It is when "the experts" are overwhelmingly aligned on one side of a trade and the consensus is strongest that a trend will continue, that it actually has the most potential to reverse.** Most of the market reversals we've seen this year are an unwinding of the so-called Trump trade - that Trump's election and the Republican sweep of Congress would herald a period of inflationary, pro-growth fiscal, tax, and regulatory policies. Instead, as the Trump administration has gotten bogged down in a myriad of other issues, with little progress on the economic front. **In general, we agree with Warren Buffett who recently said, "If you mix your politics with your investment decisions, you're making a big mistake."**

Sector Review - ***Fixed-Income:*** We think it is prudent to construct portfolios that are prepared for, and are resilient to, a range of potential outcomes. As a result, in our balanced portfolios, we maintain some exposure to core bonds, despite very low current yields, because of their risk-mitigating properties in the event of a recession or other shock. **But given core bonds' paltry yields and unattractive longer-term return prospects, we maintain meaningful exposure to other more flexible and opportunistic fixed-income funds as well as to floating-rate loan funds.** These investments should also provide some protection against rising interest rates and inflation.

U.S. Stocks: Based on our analysis of valuations and longer-term earnings fundamentals—even putting aside any near-term political or geopolitical risks—U.S. stocks present modest expected returns over the next several years. Valuation risk is high and offers minimal margin of safety in the event the optimistic scenario currently baked into valuations doesn't play out. **Therefore, we are underweight to U.S. stocks and to equity risk in general, but we don't see any particular near-term trigger for a sharp market decline.**

Foreign Stocks: Outside of the United States, we see strong potential for both improving earnings growth *and* higher valuations—leading to relatively attractive longer-term expected returns. We have a moderate overweight to both European and emerging-market stocks. **We believe the outperformance of foreign stocks still has room to run given their superior valuations and earnings growth potential versus the U.S market.** Foreign stock markets are also seeing increasingly positive investor sentiment and strong cash inflows. **More than $12 billion has flooded into U.S.-domiciled European stock funds and ETFs this year, reversing 13 consecutive months of net outflows prior to that.** Year-to-date inflows into emerging-market stock funds are close to $30 billion. Even with their strong performance so far this year, our longer-term return expectations continue to favor Europe and emerging markets compared to the United States.



Alternative Strategies: Our lower-risk alternative strategies (i.e. – arbitrage, managed futures, real estate, non-agency mortgage-backed securities, etc.) are performing well in absolute terms, but they are lagging the strong performance of U.S. stocks. **We maintain exposure to alternatives, because they should generate positive returns in the event of a recession and a bear market in stocks. Over the longer term, they also should provide attractive risk-adjusted return potential and valuable diversification to the overall portfolio. While there has seemed to be little need for such alternative strategies over the past eight years of a raging U.S. equity bull market, history teaches that this cycle will turn too and the portfolio benefits of these alternatives will then be apparent.**

Putting It All Together - We don't expect a recession in the near term, but we remain alert to and positioned to meet the high level of uncertainty that characterizes both global financial markets and the current geopolitical environment. **The stock market's calm ascendance seems to fly in the face of ongoing political uncertainty and geopolitical tumult.** That said, maintaining a degree of equanimity is a valuable attribute of successful long-term investors. Global risks *always* exist and unexpected events inevitably happen, causing markets to fall no matter their valuation. The world and financial markets have faced numerous negative shocks over the decades, but the broad economic impacts have ultimately proved transitory. **Over the long term, financial assets are priced and valued based on their underlying economic fundamentals—yields, earnings, growth—not on transitory macro events or who occupies the White House.** Therefore, we believe it is beneficial for investors not to react to every domestic political development or geopolitical event with the urge to sell their stocks nor get overly excited and jump into the market on some piece of news they view positively. Having a disciplined investment process and a focus on the long term are essential to best achieve your financial objectives.

The Water Valley Investment Team