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Asset Management • Retirement, Tax and Estate Planning • Fee Only • No Commissions • Independent Advisor

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Here is our newsletter for the 4th Quarter of 2017.

The Markets

The 3rd quarter saw strong returns for most asset classes with the exception of real estate. A significant change in market leadership has occurred year-to-date as the foreign developed and emerging market stock and bond markets are outperforming the U.S. markets. This is reversing the huge seven year outperformance by the U.S. markets

As expected the bond market continues with their low returns. However, the short end of the curve is slowly producing higher yields as short-term interest rates have been rising in reaction to the Federal Reserve's interest rate rises.

Year-to-date all asset classes are up except for the commodity market.

Asset Class Returns- Ending 9/30/17

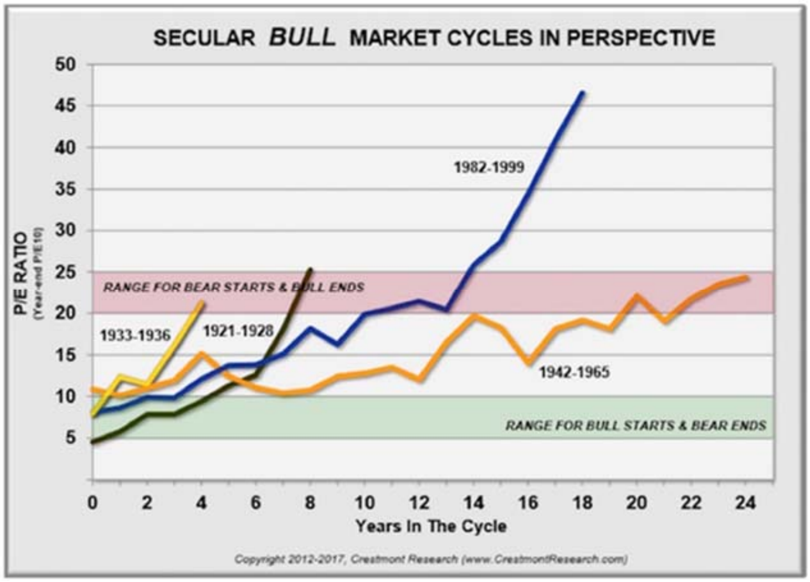
Asset Class	3rd Qtr 2017	YTD
US Large Cap Stock	4.5	14.2
US Small Cap Stock	5.7	11.0
Foreign -Developed Mkts Stock	5.4	19.9
Emerging Mkts Stock	7.8	23.6
US Intermediate-Term Bond	0.8	3.2
Emerging Markets Local Bond	3.9	15.0
High Yield Bond	1.7	6.3
Inflation-Protected Bond (TIPS)	0.9	1.7
Cash	0.3	0.7
US Real Estate	0.9	3.5
Natural Resource Stocks	6.7	9.6
Commodities	6.5	-2.7

Bubble Valuations

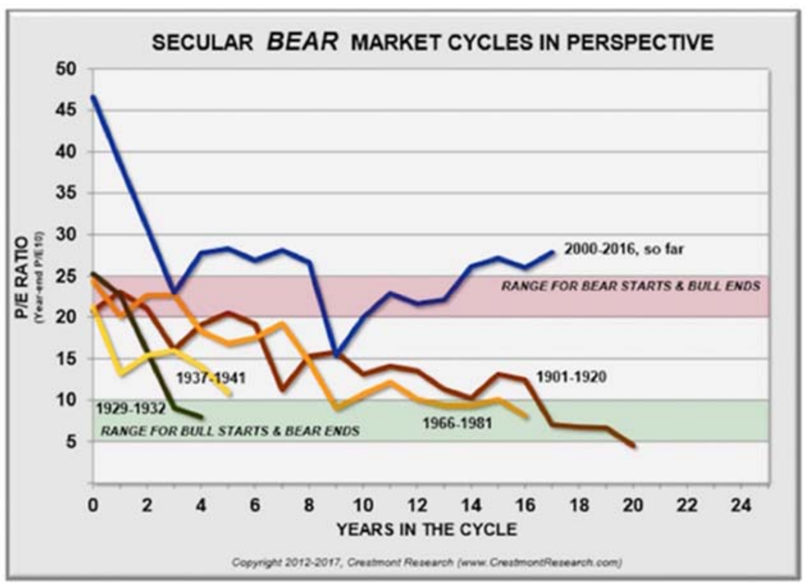
Here is an analysis from two market analysists I have not presented here in the past. I know I sound like a broken record, as about twice a year for several years I have been showing various analysis that has been showing increasingly overvalued markets here in the U.S. Bear with me.

In early August, David Stockman (former Director of the Office of Management and Budget under President Reagan) highlighted the exorbitant valuations in the tech sector. Facebook, Amazon, Google, Netflix, Apple and Microsoft saw their weighted average P/E increase by 50% over the last 30 months. Between January 2015 and early August, their collective market cap accounted for 40% ($1.4 trillion) of the S&P 500's increase in value from $17.7 trillion to $21.2 trillion. This pattern of a small sliver of tech giants accounting for a disproportionate amount of market gains is a repeat of what happened during the Internet Bubble when Microsoft, Dell, Cisco and Intel saw their market caps double from $850 billion to $1.65 trillion. At the March 2000 peak, Microsoft's P/E was 50x, Intel's was 60x and Cisco's was 200x compared to Facebook's 40x P/E, Amazon's 190x P/E and Netflix's 217x P/E today. Two years later, the four tech giants of the Internet Bubble had lost 75% of their value. Amazon stock has gone parabolic from around $300/share at the beginning of 2015 to around $1,000/share today. Netflix and Facebook followed similar patterns.

Ed Easterling has studied long term stock market cycles for many years. The following two graphs illustrate the concept of markets going thru cycles that can last for 10, 20 years or more where the stock markets exhibit higher than average and lower than average returns for many years during secular bull and bear cycles. The stock markets rarely give you the long term average of 10% per year that you read about, even over a span of 20 years.



The first chart shows four secular bull markets which have always started at P/E ratios that are very low of between 5 and 11. We are taking about 10 year cyclically adjusted ratios per Robert Shiller's P/E ratios for the U.S. large cap stock market index. All of the bull markets ended at P/E ratios of between 20 and 25 with the big exception at the end of 1999.



The second chart shows the start of secular bear markets where the P/E ratios fall from high values back down to the 5 to 11 P/E range, where the next bull market cycle begins. You will notice Ed is assuming the current secular bear market cycle that started in 2000 is not over yet, despite the big gains from the market lows in 2009. His premise is no secular bull market has started at P/Es above 11, where the markets were in 2009. Also notice the current P/E of 28 is higher than the start of any secular bear market, again except for the 2000 bear market start.

There are those who believe that things are different now. We are in a new world where earning don't matter as much, or accounting has changed to make these measures obsolete. It is my view that these measures are still applicable and they indicate a U.S. stock market that is very richly priced. While these measures do not work over the short term (6 years) we still believe they are a good indication of future stock market returns over the longer term. This is why we advise caution for investors going forward and adopt a diversified, value approach. Don't just chase what has worked over the last seven years.

Internet Insecurity

You have probably heard about the news that Equifax had a huge data breach that could potentially expose 143 million U.S. citizens' personal data. This is far from the only major data breach, just the largest to-date. I would recommend that you (and your kids) go to the Equifax website below to see if you may have been affected and to sign up for their free credit monitoring service and identity theft insurance. Also consider putting a credit freeze with the 3 reporting agencies, especially if you are retired and have no need to borrow any more.
https://www.wired.com/story/how-to-protect-yourself-from-that-massive-equifax-breach/

A client passed this on from the Denver District Attorney. It tells you all you need to know about how the credit reporting agencies use your data and how you can help protect yourself.
http://myemail.constantcontact.com/EQUIFAX-DATA-BREACH-INFORMATION-.html?soid=1121174592460&aid=uUpmAEfmNIA

I talked about cybersecurity in my newsletter one year ago here:
http://compfinancial.com/documents/2016Q3Newsletter7-11-16.pdf
The sad truth is, even though you may not be in the Equifax breach, your Social Security number and other personal data is likely already in the dark web. The best idea I have heard came from an Op-Ed in the New York Times from Bob Sullivan titled "Your Social Security Number Isn't A Secret". He suggests publishing everyone's Social Security number on the internet. "Once and for all, it would eliminate the fantasy that a Social Security number is both a unique identifier and a secret to be used as an authenticator."

There are many strategies companies are using to reduce the online threat. There are emerging technologies that are becoming available. True Key is a password manager that is using facial recognition and fingerprint technology to replace the usual login. I have not used this but there are also other password managers available that can help secure your login authentication. Lastpass and Google Smart Lock are the most commonly used.

I know all this can be overwhelming to many. I will close by just saying pay attention. Pay attention to your bank, loan and other financial accounts by reading your statements and checking them often. Be careful using email and surfing the internet as there are many imposters out there.

More Talk of Tax Reform

The President has proposed sweeping changes to the tax code. Unfortunately the proposal is only a rough framework. For example, it states changing the tax rates from five to three rates but does not state at what income those new rates start and stop. It is also advertised as a huge tax cut for most, however many of the proposals to eliminate and/or reduce deductions for state tax, deductible retirement plan contributions and others could increase taxes for many.

This will be a difficult year to do our usual year-end tax planning for our clients. It will have to wait until November or even December to see what Congress does.

Final Close of Pacific West Real Estate Fund

In our January newsletter http://www.compfinancial.com/documents/2017Q1Newsletter1-10-17.pdf we mentioned the private real estate fund we are recommending for many of our clients. The fund will be closing soon so let me know if you are interested soon. Again, it is for accredited investors.

Sincerely,

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