TOWNELEY
CAPITAL MANAGEMENT INC
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2017 First Quarter Review

April

Inauguration, Interest, Inflation

If you've been feeling nostalgic, chalk it up to current events: the first quarter brought us the return of some things we had not seen for a while. A businessman is occupying the Oval Office for the first time since George W. Bush served as president. The Federal Reserve raised its target interest rate to an upper limit of 1% for the first time since 2008. Meanwhile, inflation slightly exceeded the Fed's target of 2% per year, reaching levels last achieved in 2012. Almost every index we follow posted gains for the quarter, with domestic equities leading the charge. In fact, we rebalanced all clients' mutual fund portfolios last quarter, locking in some of the wins in a domestic market that increasingly looks overvalued.

Your Portfolio

A strategic maneuver during this period of rising values was the total rebalance we performed for all mutual fund accounts. Between January 2016 and March 31, 2017, the Standard & Poors 500 was up 21.0% and the Russell 2000 was up 30.4%. When the markets experience big gains, a few things happen. First, the value of your portfolio goes up. Second, the relative values of the asset classes in your portfolio typically change. Suppose your investment objective is 50% equity. When the equity portion of your portfolio enjoys large gains relative to the fixed income, it now, by definition, is above the 50% target we previously identified after careful consideration of your specific needs. And other asset classes will be relatively smaller since the total always adds up to 100%. When the equity portion grows, your assets are exposed to more risk than is appropriate for your portfolio, so we rebalance.

When we rebalance we bring your investment portfolio back to its target objective. In the present example, if we sell appreciated equities and invest the proceeds in other asset classes, we realize those gains and reinvest the money to keep it working for you. In this rebalance, we sold domestic equities and bought fixed income.

We had increased the allocation to international equities last year, and this move is beginning to pay off. The first quarter was strong with developed market equities up 7.2% and emerging market equities up 11.5%. The dollar weakened over the latest three months, helping to bump up gold 8.2%.

As always, if you anticipate changes in your income, expenses, employment, health, or other major life factors, please let your portfolio manager know so we can evaluate your portfolio in light of the new information.

Are US Stocks Overvalued? A Visit to the CAPE Provides the Answer

Shiller Cyclically-Adjusted P/E Ratios of Major Equity Markets

Source: Robert J. Shiller. http://www.econ.yale.edu/~shiller/data.htm

This chart uses a valuation measure to compare the relative attractiveness of equity markets in regions and countries around the world at the same time. This measure, the Shiller Cyclically-Adjusted P/E Ratio, or CAPE, is defined as the ratio of the current P/E ratio to the average inflation-adjusted price/earnings ratio of the last ten years.

As of January 31, 2017, the most expensive equity market in the world is the US, while the cheapest region in the world is Europe.

The current data suggest that tilting your equity portfolio towards the World x US would produce higher ten year returns than investing only in the US, the World or in Japan. We would note that the CAPE measure is useful for long term relative comparisons of attractiveness but suggests nothing about the near term.

The high CAPE ratio for US stocks tells us that expectations are high. Investors expect more economic growth, higher profits, substantial tax reform, and modest inflation. However, none of these possibilities is a given. Further, it could be that these possibilities have already been priced into the stocks, meaning the stocks' prices will not necessarily rise even if the expectations are met.

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You Asked: "Why Does the Federal Reserve Want Inflation?"

Nobody likes to pay more for things, so it seems odd that policy makers at the Fed encourage inflation by setting a target inflation rate and steering our economy toward it. Why would they do that?

It's an economic version of "the enemy of my enemy is my friend." The Fed does not really hope for inflation; instead, they are determined to keep deflation—the "enemy" of inflation—out of our economy. And because policy cannot precisely govern our economy, the Fed targets a low level of inflation in the hopes that shooting for that figure will keep us out of the deflationary weeds. Chair Janet Yellen characterizes the target as "symmetric," elaborating, "It's a reminder [that] 2% is not a ceiling on inflation. It's a target." (quoted in Wall Street Journal, "Fed Raises Interest Rates, Remains on Track to Keep Tightening," March 15, 2017)

Global deflationary fears appear to be receding. Europe, for example, is approaching its inflation target. Quantitative easing programs are subsiding as recovery takes hold. But what is it about deflation that makes it so fearsome? It wrecks economies. Suppose you were planning to buy a new car for $40,000, but you knew the price would be more like $35,000 if you held off for a few months. Odds are you would save your $5,000 and defer your purchase. When folks put off buying cars, car manufacturers lay off workers. Laid-off workers miss mortgage payments. Multiply the effects of this simplistic example across a complex economy, and you can see why central banks fight hard to prevent deflation.

But maybe you are thinking, "But inflation is harmful too, right?" Right—when we are looking at high inflation. In 1980, the price of a barrel of oil rose to $37.92 (over $109 in today's dollars). The resulting spike in fuel prices drove up the price of producing and transporting products and the cost of filling up the family sedan, and inflation spiraled. A small amount of inflation, though, usually results from conditions that indicate a positive economic trend. Wages rise when unemployment drops. Prices go up when companies are confident they can boost prices to cover the increase in payroll. That corporate confidence results from solid profits.

Help for Trustees

Many people enjoy serving in the role of trustee for a family trust. Others find the task stressful, unpleasant, or burdensome. Yet corporate trustees can be pricey and lack in personal service. Some firms will provide trust services only if you also put the trust's assets under their management. This option doubles your due diligence, as you need to verify that the trust services meet your specific needs and ask all the questions you would ask when choosing an investment advisor.

Another alternative is available, though. Personal trustees specialize in service tailored to suit your family's needs. Stand-alone trust services also allow you to specify the investment counselor to manage the trust's assets. Your Towneley portfolio manager can provide referrals if you would like to see whether trustee services are right for you. We're as close as your phone or your email.

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Economic Roundup

The United States

The surge in domestic equities following the election last November, nicknamed the "Trump Trade," seems to be coming to an end. Campaign promises of speedy tax reform, increased infrastructure spending, and deregulation are not materializing as quickly as some investors had hoped. Then, near the end of a terrific quarter in the markets, came the health care bill drama. The bill intended to repeal the Affordable Care Act was withdrawn from the House of Representatives before a vote when it became clear the bill would not pass. The S&P 500 nearly flattened on that news, rising only 0.2% between the date the bill was withdrawn, March 24, and April 17. Further, the administration's efforts to limit foreign entry into the US has met judicial roadblocks, another indicator that the president's agenda is facing some tough battles. It also now appears that overhauling the tax system and deregulating business may present larger challenges and take longer than some investors had anticipated in the months following the election.

Economic indicators remain positive, however. The Fed raised interest rates in March, signaling perceived strength in the US economy. Chair Janet Yellen said the economy is doing well and people can feel good about the outlook. The US has added jobs for 77 consecutive months as the unemployment rate has dropped to 4.5%. Gold did well during the quarter as global political uncertainty increased and the dollar weakened. Corporate profits continue to improve but may face a headwind as wages increase.

Europe

In Europe, growth picked up in the second half of 2016 and momentum should continue in 2017, barring any big jolts due to elections. Inflation increased to 2.0%, the highest reading since 2013, causing many to think the ECB would soon begin to taper its bond-buying program later this year.

The results of the Brexit vote last June and US elections last fall have renewed attention to populist movements. Speculation about the rise of populism in Europe focused worldwide attention on Parliamentary elections in the Netherlands, of all places, in mid-March. In that nation, the populist party did not secure a majority of seats. France's presidential election was held on April 23, with a runoff set for May 7, and nearly a third of French voters remain undecided. If the populist candidate, Marine Le Pen, wins the runoff, we may see increased volatility in the EU.

Asia

In Asia, Japan remains in the spotlight as her economy improves. Core CPI has returned to positive territory, and forecasters predict a slow increase, topping 1% in fiscal 2019. Meanwhile, real GDP grew over 1% (annualized) in the second half of 2016 and is expected to grow 1.3% in fiscal 2017.

Emerging Markets

Markets in the developing world notched a strong quarter, up 11.5%. Some of these gains were due to a weaker dollar, but in local currencies, the increase for the quarter was up 7.8%. China did well, up 13.1% as its economy continues to grow. In the first quarter, GDP was up 6.9%, mostly driven by Chinese government investment and strong exports. However, debt has been growing rapidly as the government borrows money to pay for infrastructure projects. Mexico was one of the best-performing countries during the quarter, up 16.1%. Our new administration's threats of trade tariffs on Mexican exports have muted over the past few months, helping the Mexican economy and stock market.

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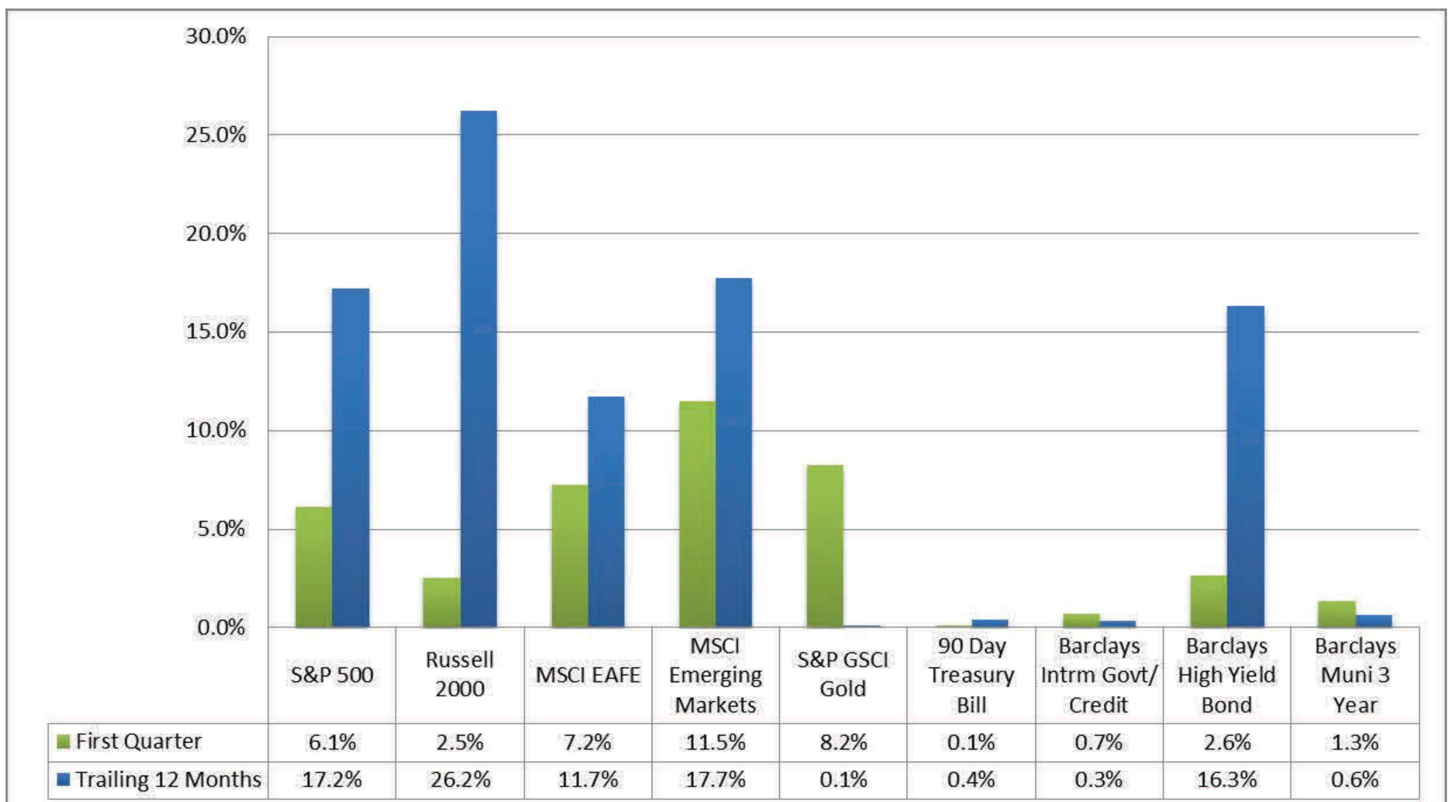
Market Returns
First Quarter 2017 and Trailing 12 Months



	S&P 500	Russell 2000	MSCI EAFE	MSCI Emerging Markets	S&P GSCI Gold	90 Day Treasury Bill	Barclays Intrm Govt/ Credit	Barclays High Yield Bond	Barclays Muni 3 Year
First Quarter	6.1%	2.5%	7.2%	11.5%	8.2%	0.1%	0.7%	2.6%	1.3%
Trailing 12 Months	17.2%	26.2%	11.7%	17.7%	0.1%	0.4%	0.3%	16.3%	0.6%