A Year in Review and Ahead

January 1, 2018

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Past performance is no guarantee of future results.

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Introduction

I'm Ken Melotte, President of Melotte Financial Advisors, LLC (MFA). MFA is an *independent* and *objective*, *fee-only* investment advisory firm providing customized financial planning and investment management services. MFA grew almost 50% in 2017!

On many fronts, 2017 was a year for the ages and will likely go down in history as quite significant. There were several records set by the markets in terms of returns, volatility and valuations.

The purpose of this commentary is to review the current state of the markets, summarize performance for 2017 and consider possibilities for what lies ahead.

The eight-year period since 2009 has produced one of the strongest, longest bull markets in history. Will the next eight years look like the previous eight?

In this Review you'll find the following sections:

- Introduction
- Interesting Stats From 2017
- 2017 Market Performance Table
- Warren Buffet Indicator
- Financial Health of Consumers
- Yield Curve
- Positives
- Market Valuations
- Silver Lining
- Cryptocurrencies
- Client Portfolios
- Sources

Let me know if you have any follow-up questions or if you'd like to discuss my advisory services in more detail.

Kindest Regards,

Ken Melotte III, CFP®

Interesting Stats

Cryptocurrencies

1. The market cap for the top 20 cryptocurrencies rose to $512 billion from $17 billion a year earlier. A 2,891% increase.[5]

Market Returns and Volatility

2. The S&P 500 did not have a 3% drawdown the entire year. In fact, the drawdown of –2.8% was the 2nd most mild on record. The mildest was in 1995 (-2.5%).[5]

3. The monthly volatility in stocks (3.9%) & bonds (1.5%) in 2017 was lower than any other 1-yr period in history. [5]

4. Over 95% of trading days in 2017 for the Dow had an intraday range (high to low) of less than 1%, the least volatile year in history.[5]

5. The S&P 500 Total Return index has been positive 14 months in a row. That's the longest streak in history. 2017 was also the first calendar year where that index was positive all 12 months. [5]

6. The Dow Jones Industrial Average closed at a record high 71 times in 2017. That's more than any other calendar year in history. The Dow has also racked up 87 record closes since the 2016 presidential election.

7. The S&P 500 (total return) finished higher for the 9th consecutive year, tying the record run from 1991-1999. [5]

8. 0.2% of NASDAQ components accounted for a whopping 45% of gains. [1]

Market Valuations

9. The most historically-reliable valuation metrics for stocks have exceeded all prior periods, including 1929 and 2000, making the current market the most overvalued in history.[8]

10. The FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) + Microsoft have experienced a 50% spike in P/Es in less than 3 years. [1]

11. FAANGs account for more than 40% of Nasdaq and 13% of S&P 500 indices.[1]

Economic

12. GDP growth during the Depression-ridden 1930s was 1.3% annualized. GDP growth for the nine years from 2007- 2016 was also 1.3% annualized.[1]

13. The Federal Funds Rate (controlled by the Federal Reserve) remains just slightly above previous record lows (from early 2000s) even though we're almost nine years into the recovery.

14. "[T]here are approximately 94 million full-time workers in private industry paying taxes to support 102 million non-workers and 21 million government workers."[7]

Company-Specific Anecdotes

1. Ford is valued at $7,000 per car produced while Tesla is valued at $800,000 per car produced.[1]

2. McDonalds experienced roughly no revenue growth from 2008 to 2016 but had 154% growth in debt and 200% increase in share price.[1] The scary part is that McDonalds is not an outlier. Chart below shows same data but for the five-year period from 06/2012 – 06/2017.

5 Year Percentage Change (6/2012 - 6/2017)

Name	Ticker	Revenue Growth	Price Change	Shares Outst.	Debt Outst.	Market Cap : Sales
YUM! BRANDS INC	YUM	-54.29%	58.91%	-19.25%	197.46%	89.41%
PHILLIPS 66	PSX	-52.03%	175.60%	-3.84%	24.78%	317.92%
SEAGATE TECHNOLOGY	STX	-46.32%	34.13%	-0.80%	75.38%	103.61%
VALERO ENERGY CORP	VLO	-39.79%	248.72%	-10.03%	20.52%	275.29%
MOTOROLA SOLUTIONS INC	MSI	-34.51%	76.41%	-7.49%	191.37%	54.09%
EBAY INC	EBAY	-31.49%	117.52%	n/a	447.56%	n/a
SYMANTEC CORP	SYMC	-29.56%	124.57%	-11.10%	103.48%	131.64%
LYONDELLBASELL INDU-CL A	LYB	-25.29%	145.96%	-10.38%	108.11%	96.64%
ASSURANT INC	AIZ	-24.83%	174.17%	-18.00%	16.89%	152.98%
ILLINOIS TOOL WORKS	ITW	-19.36%	179.75%	-4.96%	64.11%	140.95%
MERCK & CO. INC.	MRK	-19.34%	53.37%	-2.89%	31.13%	71.15%
DEERE & CO	DE	-17.20%	55.30%	-2.53%	19.48%	48.44%
AON PLC	AON	-16.06%	212.31%	-4.33%	31.92%	171.83%
PFIZER INC	PFE	-14.15%	55.22%	-3.23%	12.65%	35.57%
MARATHON PETROLEUM CC	MPC	-13.61%	149.69%	-3.25%	277.99%	105.31%
KIMBERLY-CLARK CORP	KMB	-13.57%	46.57%	-2.22%	28.02%	61.41%
NETAPP INC	NTAP	-13.01%	37.52%	-7.85%	57.56%	7.13%
MCDONALD'S CORP	MCD	-11.92%	73.05%	-19.80%	112.23%	58.62%
COLGATE-PALMOLIVE CO	CL	-10.34%	39.96%	-1.52%	24.65%	46.99%
Average		**-25.61%**	**108.35%**	**-7.42%**	**97.12%**	**109.39%**

Market Performance

Notice that every major asset class was positive for the year. Top performer of the year goes to emerging market stocks. Did you have those in your portfolio?

Index / ETF	Proxy For	Q4 Return	2017 Return
Bloomberg Barclays US Aggregate	U.S. Bond Market	0.39%	3.54%
Bloomberg Barclays Global Aggregate X-US Hedged	Foreign Bond Market	1.13%	2.48%
Russell 3000	Broad U.S. Stock Market	6.34%	21.13%
S&P 500	U.S. Large Cap Stocks	6.64%	21.83%
Russell 2000	U.S. Small Cap Stocks	3.34%	14.65%
MSCI EAFE (Local Currency) Net	Foreign Developed Stock Market	3.66%	15.23%
MSCI EM IMI Net	Foreign Emerging Stock Market	7.67%	36.83%
Bloomberg Commodity	Commodities	4.71%	1.70%
FTSE / EPRA NAREIT Global REITs	Global Real Estate Investment Trusts	3.38%	7.98%
SPDR Gold Trust ETF (GLD)	Gold	1.70%	12.81%

Warren Buffett Indicator

Warren Buffett, who once said "…be fearful when others are greedy and greedy only when others are fearful,"[2] is holding over $100 billion of cash in Berkshire Hathaway.[3] Warren Buffett, in 2017, expressed very little concern about stock valuations. In fact, he said as much in direct response to a question I submitted to CNBC via Twitter,[4] but actions speak louder than words.

Mr. Buffett and his team at Berkshire are obviously not finding attractive investment opportunities so cash continues to build each quarter. Remember that it was Berkshire's large cash position in 2009 that allowed it to make very profitable, opportunistic investments when others were fearful and selling.

For those of you regular readers, it will come as no surprise that I have concerns about the market currently. Specifically, I believe we're already in extra innings of this bull market with the most reliable valuations metrics flashing red. There are certainly small pockets of positive news that could serve as catalysts to push the market higher for a time, but, if the market is indeed a "weighing machine in the long run," as Benjamin Graham (the man who Warren Buffet describes as the second-most influential person in his life) suggests, then the scales are indicating extremely "light" returns for the next 10-12 years with a significant bear market in the interim.

Below you'll find what is oft-termed the "Warren Buffett Indicator." It's a chart depicting the stock market's total value divided by GDP (Market Cap / GDP) and was referenced by Mr. Buffett in a 2001 Fortune interview when he said, "it is probably the best single measure of where valuations stand at any given moment."[9] This metric now exceeds the prior record set at the peak of the dot-com bubble.

Financial Health of the Consumer

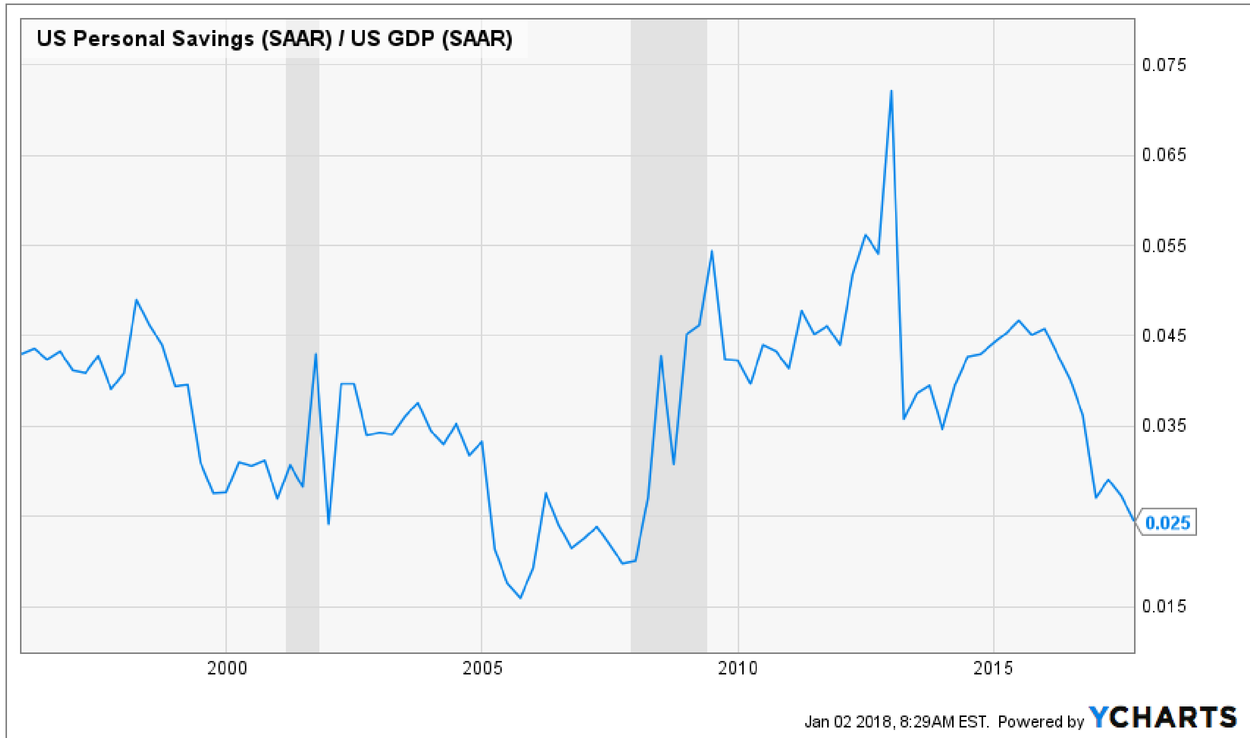
> "Two-thirds of Americans don't contribute anything to retirement. Only 32 percent of the $100,000+ crowd maxes out the contribution. When the top 10 percent of the younger boomers have two multiples of their annual salary stashed away, you've got a problem… Half the boomers have no money set aside for retirement."[1]
>
> **David B. Collum**

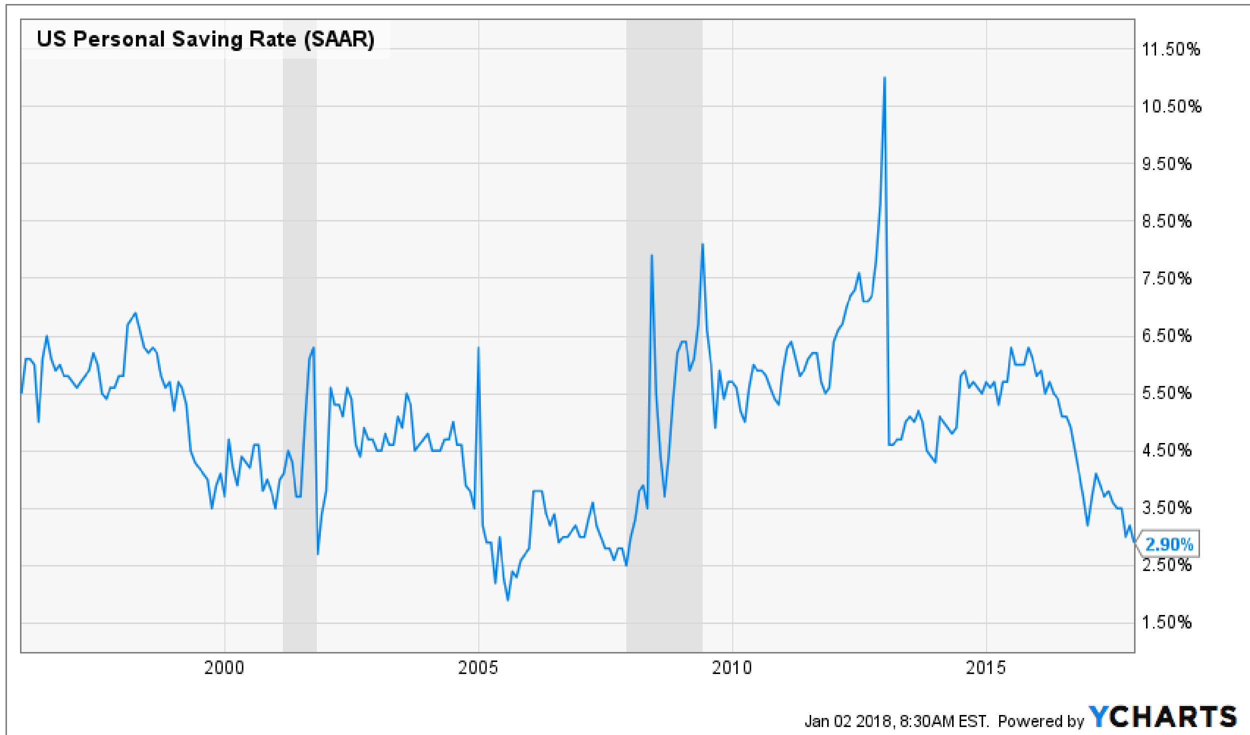
Personal savings as a percentage of GDP is at the lowest level in ten years. The personal savings *rate* is also at its lowest level since the eve of the Great Recession. Charts follow on the next page.

For the little savings that do exist, savers are getting nothing in return. "Bank of America, for example, paid $200 million in interest on $500 billion of deposits while those same retail depositors paid $4.1 billion in fees, which corresponds to a negative interest rate of 0.64 percent."[1]

> "Wealth is made, mined, grown, or coded, only then do you get to consume it. Wealth is extinguished by consumption, depreciation, and destruction."[1]
>
> David B. Collum

Shaded areas indicate recessions.

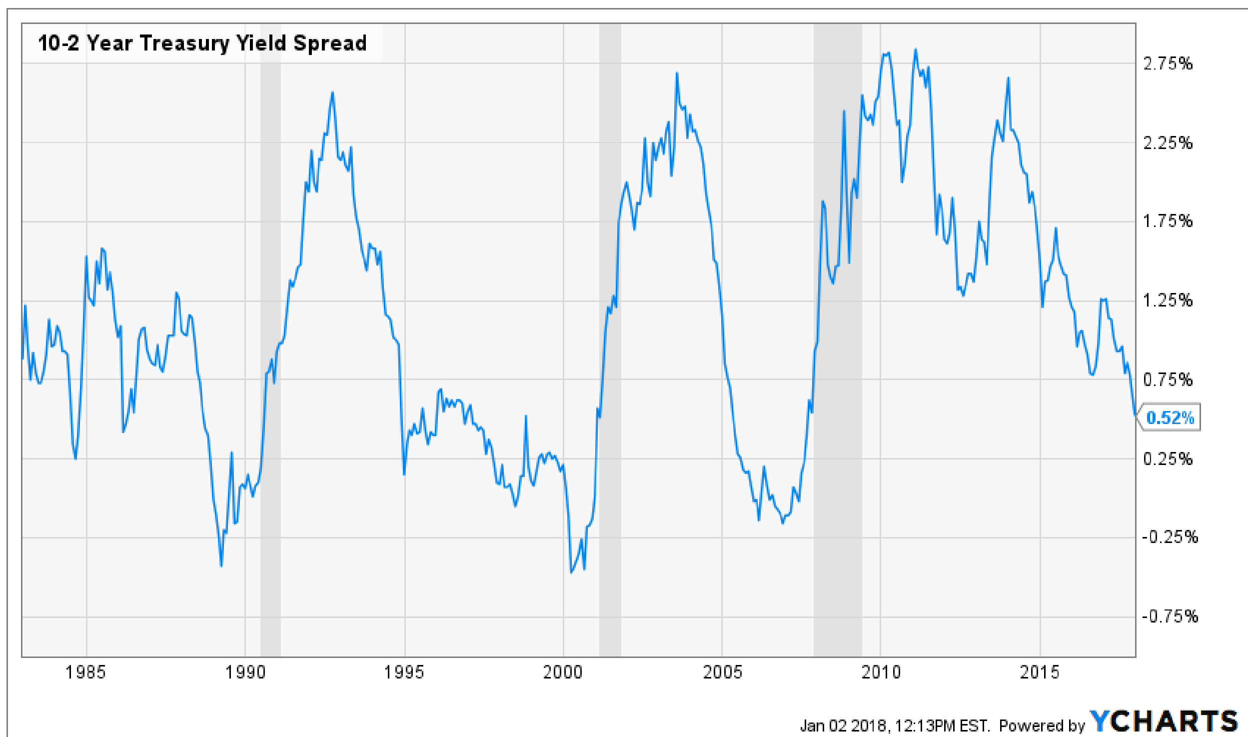




Yield Curve

One reliable indicator of recessions in the past has been the yield curve. The yield curve is simply the line formed when you plot Treasury yields of varying maturities. The curve is typically described using the differential that arises when subtracting a short-term Treasury yield from a long-term Treasury yield. Historically, when the yield curve inverted (i.e. short-term yield exceeded long-term yield) recessions followed closely behind.

In the chart below, the line plots the yield differential between a 10-year and a 2-year Treasury. The higher the line the steeper the curve and vice versa. Recessions are shaded to make it easier to identify the relationship between yield curve flattening and recessions.



The yield curve is not yet flat although it certainly has become much flatter

Many consumers are already immunocompromised because of low savings, high debt and high rent-to-income ratios, which implies the next recession will be very painful. A recession will magnify the nation's savings deficiency.

Positives

I often get asked, "Do you see *any* positives?" So let me highlight a few here as well.

The labor market appears to be tight when referencing traditional employment measures. There also appear to be "Now Hiring" signs posted everywhere. Although, to be fair, when labor force

participation, wage growth, and employment-to-population ratios are considered, the picture is bleaker. And as for those "Now Hiring" signs… they tend to be for low-paying, part-time work.

Tax reform could act as a temporary injection of stimulus, and, from a principled standpoint, I love that Americans will get to keep even a tiny bit more of their property. However, tax cuts aren't as effective if not accompanied by spending cuts.

The reason is that the marginal fiscal gap created if spending is not also reduced must still be funded. If spending won't be funded via current taxation, it will be funded through more borrowing (pushing interest rates higher than they would be absent that marginal activity) and money printing from the Federal Reserve (pushing inflation higher than it would otherwise be absent that activity). Any marginal borrowing will need to be paid with future taxes and / or inflation anyway.

One way or another we pay for additional deficits in the form of higher interest rates, higher prices and future taxation. That's why Congress must match tax cuts with spending cuts to achieve a more sustainable impact on the overall economy. If Congress can tackle its spending problem in a significant way, then I would get excited about long-term growth prospects for the U.S. economy.

As far as the market itself goes, I haven't yet seen the capitulation point. The capitulation is when anyone left on the sidelines jumps into the market because they're tired of sitting it out or when investors call their advisors about putting more money into stocks. I haven't gotten the sense of a euphoric top yet. There still seems to be measured optimism as opposed to delusional euphoria, which usually characterizes the last phase of the bull market. This implies there may still be room to run.

Lastly, and this coincides with the point immediately above, certain valuation metrics are reliable for predicting returns over the subsequent 10-12 years, but they are catastrophically unreliable over short periods of time. Instead, short-term market movements are primarily driven by investors' emotions.

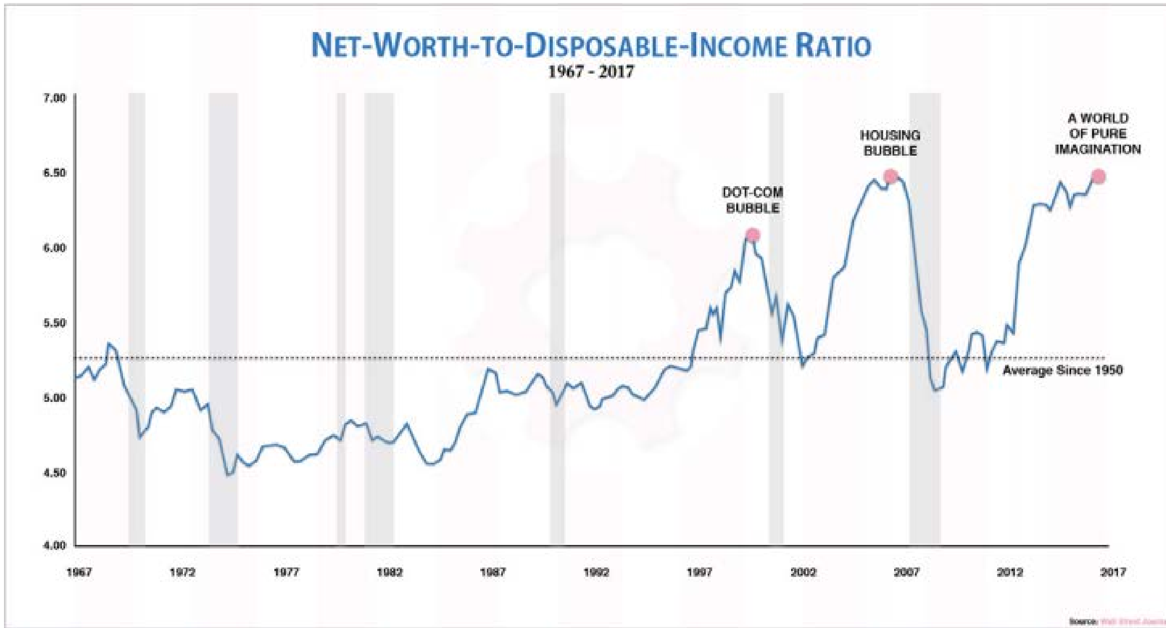
> "The "hinge" that distinguishes an overvalued market that continues to advance from an overvalued market that drops like a rock is purely psychological – it's the preference of investors toward speculation or risk-aversion, typically encouraged by short-term, cyclical factors that lead investors to feel optimistic or fearful."[8]
>
> John Hussman, Hussman Funds

Investor emotions can be difficult to measure and predict, but we can make inferences using market internals and investor/consumer sentiment studies. Currently, per John Hussman, market internals have not expressly deteriorated indicating there may still be some appetite for speculation. Keep in mind, however, emotions turn very quickly as greed can quickly deteriorate into fear.

Emotions become heightened AND more volatile when two factors are present: (1) investors have been lulled into false sense of security by a steadily climbing market with very little volatility (2017), and (2) investors have taken on more risk than they can truly tolerate either emotionally or financially.[10]

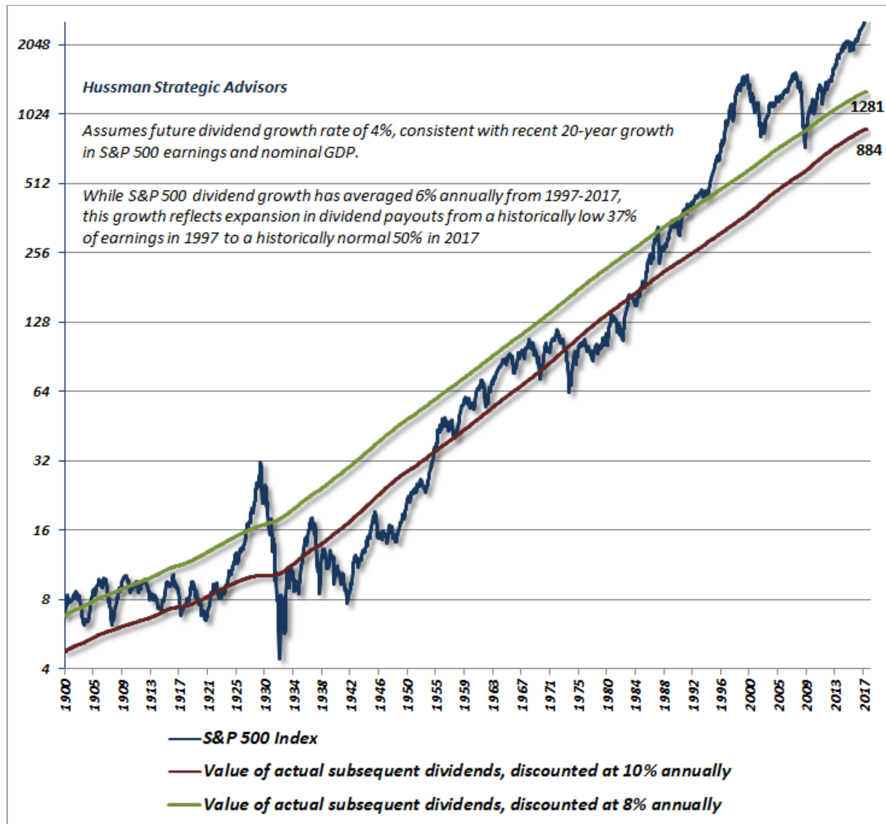
More on Market Valuations

Here are additional valuation metrics to provide a sense for where the market stands today relative to history. It should be clear we are residing in an extreme market environment.

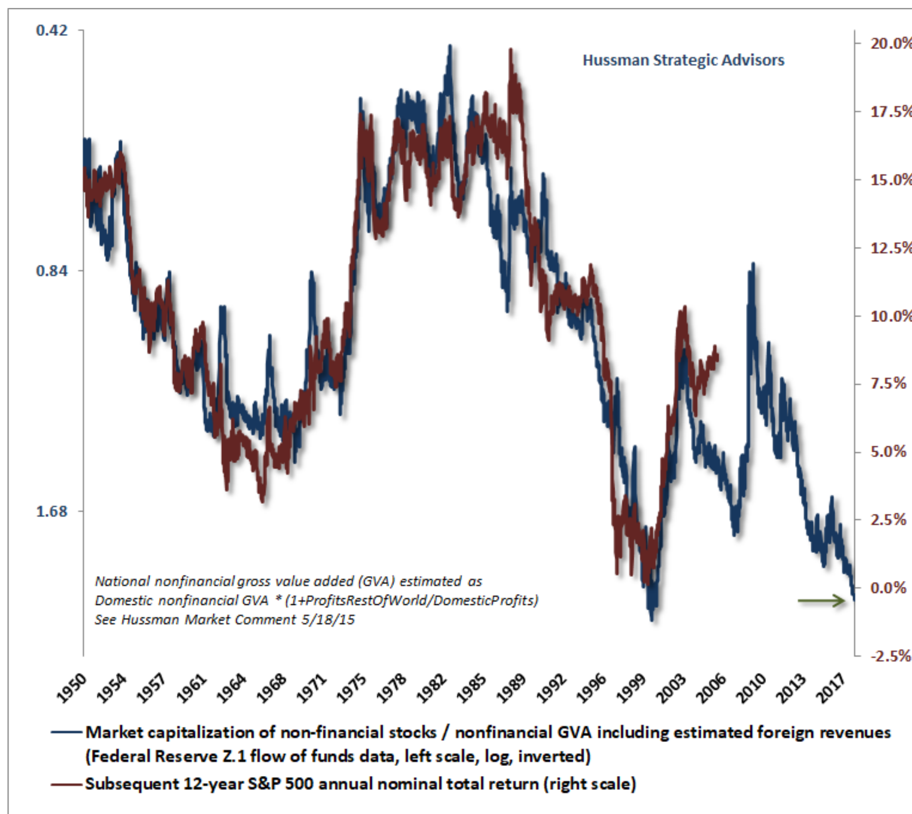


Grant Williams: Net-Worth-To-Disposable-Income Ratio[11]

Grant Williams: S&P 500 Median Price-To-Revenue Ratio[11]



John Hussman: (Top) Est. value of S&P 500 using dividend discount model[11]



Household Financial Assets to GDP

Source: YCharts

"[I]f Wall Street believes that current valuations are actually "justified," that 10-12 year S&P 500 total returns are likely to be meaningfully positive, or that the S&P 500 will avoid a collapse on the order of -65% over the completion of the current market cycle, my view is that these beliefs are strenuously at odds with the evidence from a century of market history."[8]

John Hussman, Hussman Funds

"Above-average valuations correspond to weaker returns, and below-average valuations correspond to stronger returns. This isn't an accident. Rather, it should inform investors that the long-term returns they expect from stocks are tightly related to the prices they pay."[8]

John Hussman, Hussman Funds

"Regression to the mean is a force of nature. It is also a mathematical truism that markets reside below the mean for half of their price-weighted existence. The failure to go through the mean in '09 is an anomaly caused by global central bankers that remains as an IOU on investors' balance sheets and foreshadows trouble to come."[1]

David B. Collum

The Silver Lining

The next bear market may create a once-in-a-generational investment opportunity for those who have discipline to avoid chasing absurd prices. When the next bear market comes the many “zombie” corporations being propped up by cheap debt around the world will fail and prices of remaining assets will drop significantly. The assets that remain will likely be strong ones with potential for large subsequent gains. This opportunity will likely present itself well before 10-12 years is up. **The only investors able to take advantage of these opportunities, however, will be those with reserves and relatively little debt.**

I believe this is why Warren Buffett’s Berkshire is sitting on a record cash hoard. Whether he’s intentionally building cash for the ultimate correction or the cash buildup is just a byproduct of not finding opportunities at attractive prices, he’s going to be in a wonderful position when the “music stops.”

Cryptocurrencies and the Blockchain

No 2017 review is complete without at least mentioning cryptocurrencies.

I believe cryptocurrencies and blockchain technology are here to stay and will be a game changer on par with the internet. HOWEVER, I also believe that novelty and enormous returns have resulted in an irrational mania driving cryptocurrencies and related companies into one of the greatest bubbles of all time. All the hallmarks of a mania are there. Lot limited to the fact that a simple company name change that incorporates the word “blockchain” results in immediate 100%-200%+ stock price gains.

I sold the little Bitcoin I had earlier this year when Bitcoin was trading around $7,200. It turned out I was quite early, but it was still a handsome return. To my mind it was a gamble, not an investment. No different than betting at a casino, which is exactly how you should treat it if you’re considering buying Bitcoin or any other cryptocurrency. Only use as much money as you’re comfortable completely losing.

My strategy at this point is to stay out until the bubble bursts and then scoop up companies building their infrastructure around blockchain technology, which I believe could change how we interact and conduct business in ways we can’t even yet imagine. After all, when the dot-com bubble burst the NASDAQ index lost over 80% and most of the dot-com companies went out of business. The companies who remained after the bust (e.g. Amazon) who leveraged the power of the internet turned out to be extraordinary investments. I think the same could happen with this new technology. We’ll see which cryptocurrencies and related companies withstand the bust. Again, this is pure speculation. No fancy analysis here.

What I’ve Done in Client Portfolios

You may be wondering how I’ve positioned portfolios considering all this information.

My approach to portfolio management is to establish a long-term neutral portfolio that provides the greatest probability of achieving financial independence in a variety of market environments, which can only be identified with the aid of robust financial projections and simulations.

To further add value over a full market cycle, I then manage portfolios within a range around that neutral. If market valuations look relatively cheap, I will make the portfolio slightly more aggressive. If market valuations look expensive, I make the portfolio slightly more conservative. The range forces discipline into the process and mitigates the risk of emotional decision-making, which can be a major impediment to achieving financial objectives.

As you can guess given my concerns with market valuations, I’ve positioned portfolios on the more conservative end of each client’s respective range. Therefore, clients still maintain a diverse mix of traditional bonds and stocks but in a slightly more conservative posture. Ultimately, client portfolios must be appropriate for their unique goals, circumstances and expertise.

At a more granular level, I’ve eliminated foreign bonds from portfolios in favor of U.S. bonds because I don’t think investors are being compensated for the risks. I’ve also eliminated high yield bonds as they tend to be highly-correlated with stocks, which is not what I want in my bond sleeve when I’m worried about stock market valuations.

I’ve also begun incorporating gold mining companies and energy producers in anticipation of a weaker dollar and relative commodity strength in 2018.

For a few clients where appropriate, I’ve incorporated tail-risk hedges in the form of options, and for others I’ve incorporated different options strategies to enhance income.

Some clients, especially those with heavy bond allocations, have shorter-term bonds to hedge interest rate risk a bit.

Clients with heavy equity allocations may also have some hedged strategies to hedge the equity market risk even further.

No two portfolios are exactly alike as they are all customized.

I’m maintaining neutral allocations to foreign developed and emerging market stocks.

I recommend many of my clients carry cash reserves outside the portfolio.

Please reach out if you’d like help structuring your portfolio to give you the greatest probability of becoming and remaining financially independent across a variety of market environments.

Sources

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