

2018 Market Outlook: Cautious Optimism or Put on Hardhats?

Stuart P. Quint, CFA

Ambassador Wealth Management

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Our 2 Cents



- Fundamentals are good, but...
- Valuations are high (stocks, bonds, real estate)
- 2 simplistic scenarios:
 - Fundamentals remain stable to better, valuations will track growth (for assets that are based on growth, not merely stable fundamentals), OR
 - Fundamentals deteriorate (particularly credit), valuations decline as much as or initially more than fundamental deterioration.

If History Is a Guide, 2018 Will Differ from 2017

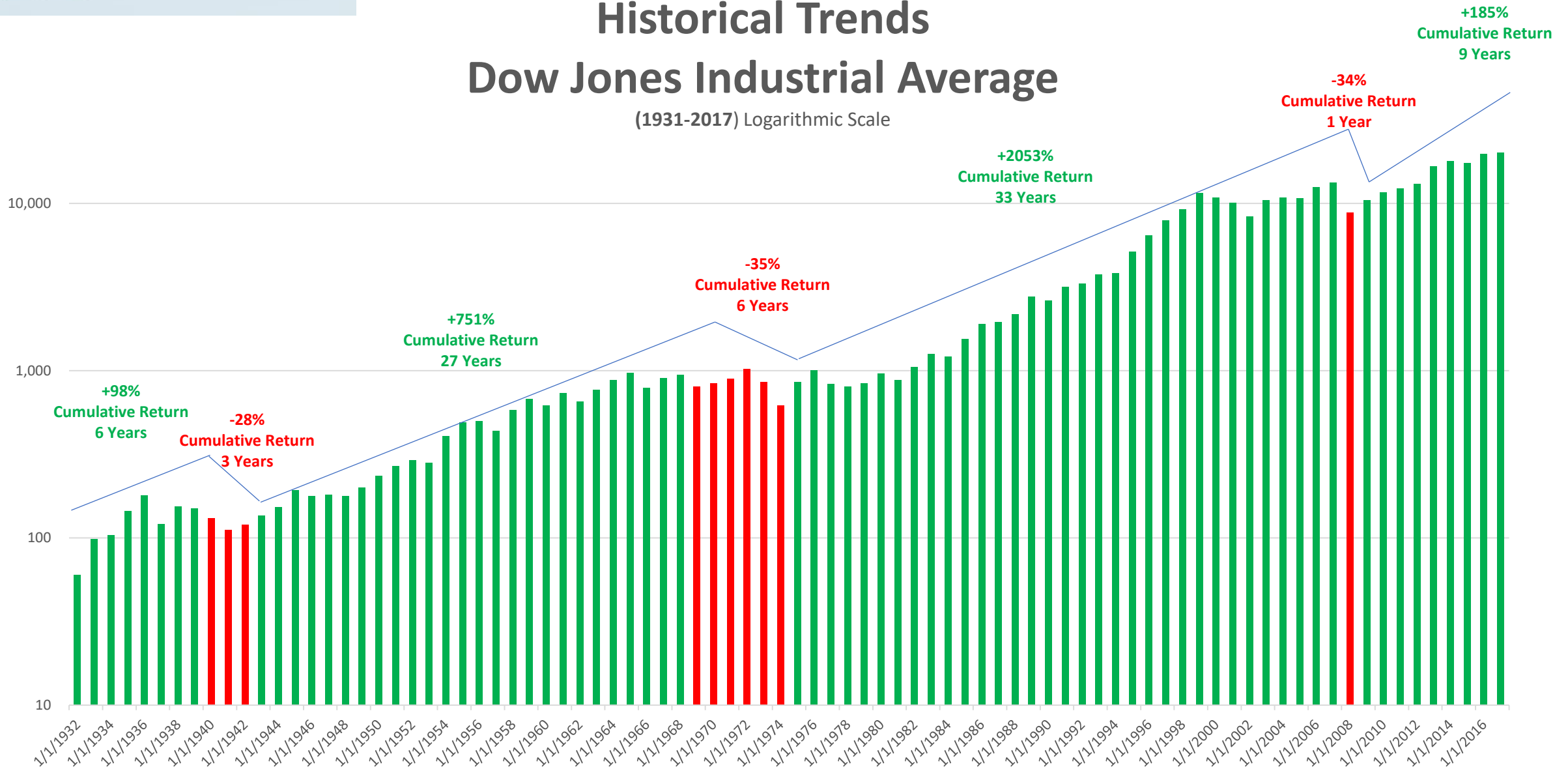
Historical S&P 500 Performance after "Low Vol" Years (Since 1945)						
Calendar Year	Year Drawdown	Year Performance		Calendar 1 Year Later	1 Year Later Drawdown	1 Year Later Performance
1954	-4%	45%		1955	-11%	26%
1958	-4%	38%		1959	-9%	8%
1961	-4%	23%		1962	-26%	-12%
1964	-4%	13%		1965	-10%	9%
1972	-5%	16%		1973	-23%	-17%
1991	-6%	26%		1992	-6%	4%
1993	-5%	7%		1994	-9%	-2%
1995	-3%	34%		1996	-8%	20%
2013	-6%	30%		2014	-7%	11%
2017	-3%	20%		2018	-11%	???

Source: Strategas Research.

Historical Trends

Dow Jones Industrial Average

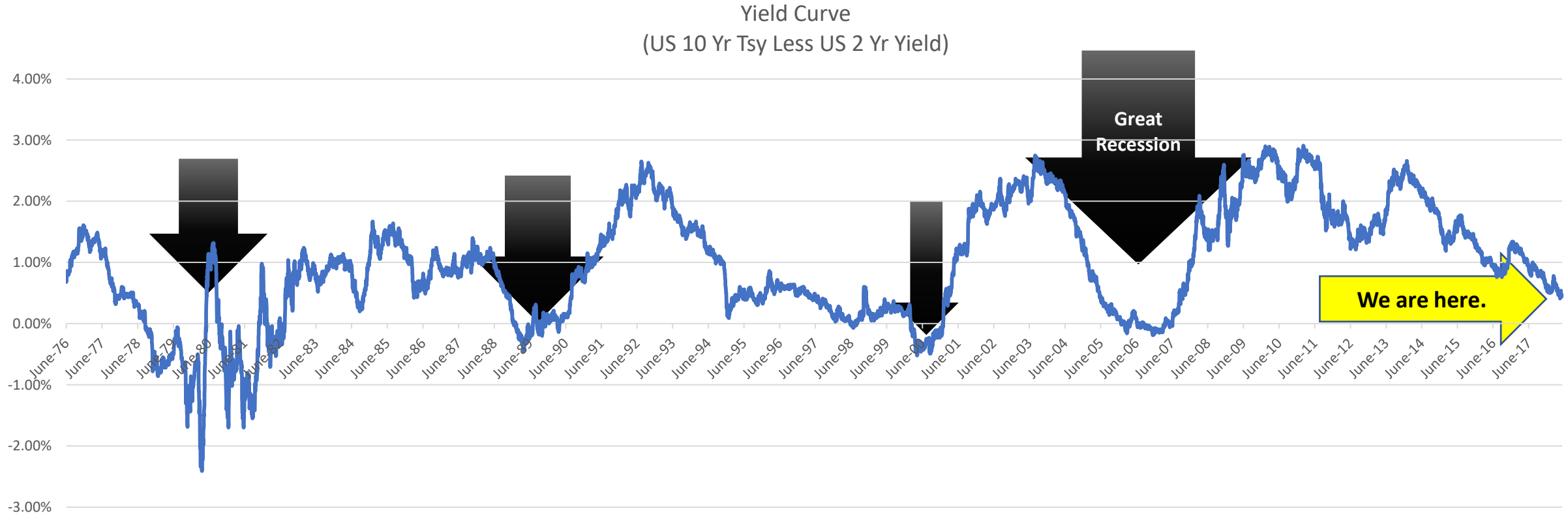
(1931-2017) Logarithmic Scale



Source: Ycharts and Ambassador Wealth Management estimates. Cumulative returns reflect gross returns (no fee) on the year-end price index of the Dow Jones Industrial Average. Cumulative returns in green represent bull markets when the index advances +20% or more from its previous year-end trough. Cumulative returns in red represent market declines of -20% or more from the previous year-end peak.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results.

Negative Yield Curves = Recessions (and Bear Markets) 1976 - 2018

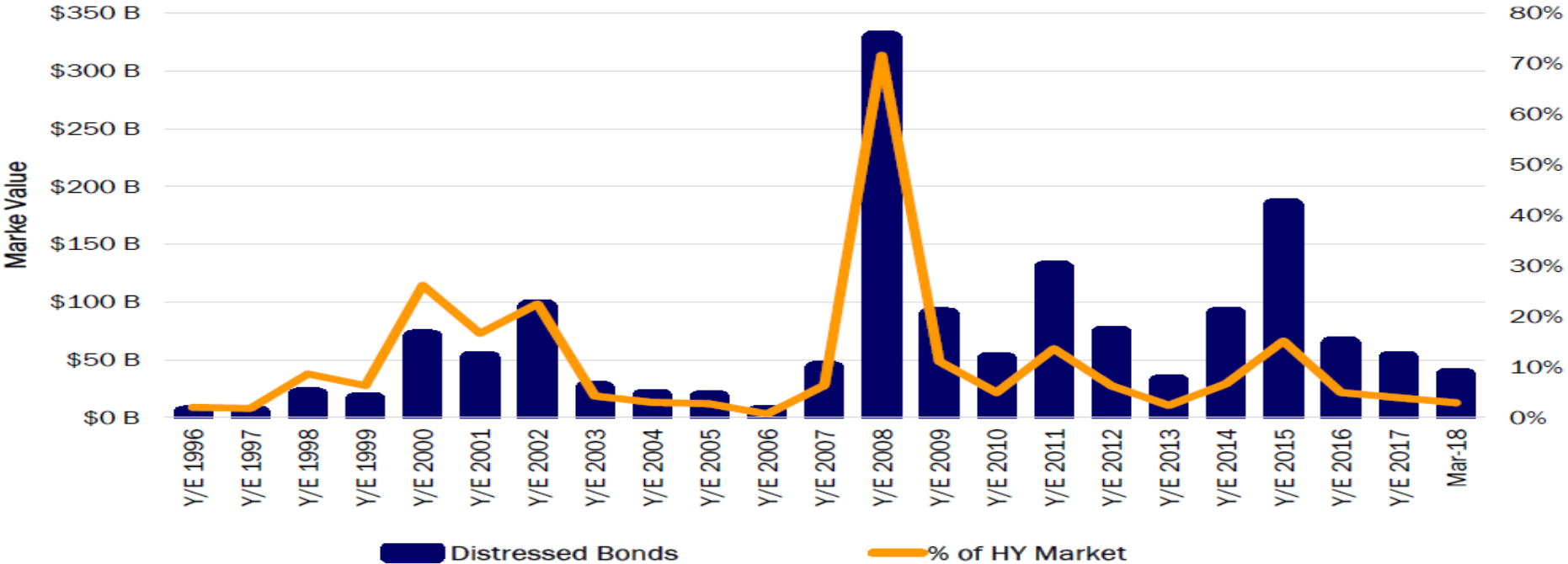


Source: Y-Charts.com and Ambassador Wealth Management.

Little Signs of Distress in Risky Corporate Credit



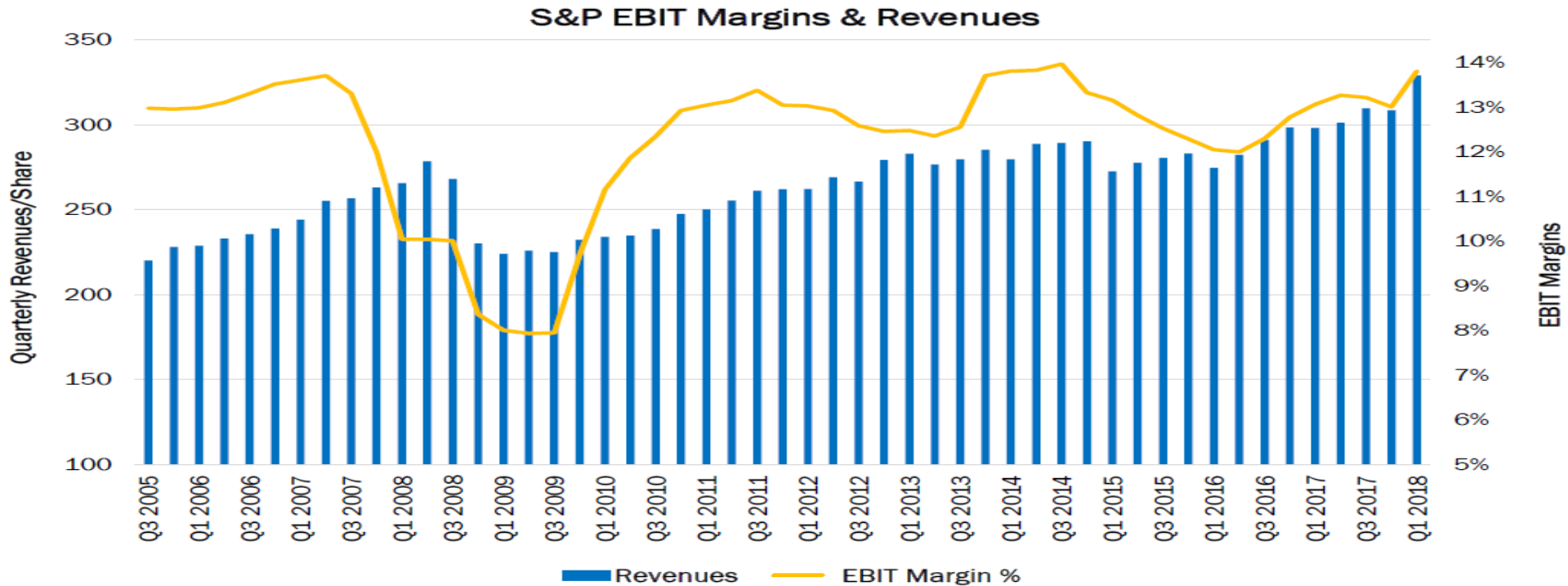
High Yield Bonds Trading at Distressed Levels



The “distress ratio” is the portion of the high yield market that is trading at a credit spread of 1000 basis points or greater over the equivalent US Treasury. The graph shows the distress ratio since 1996.

Source: Bank of America Merrill Lynch Bond Indices

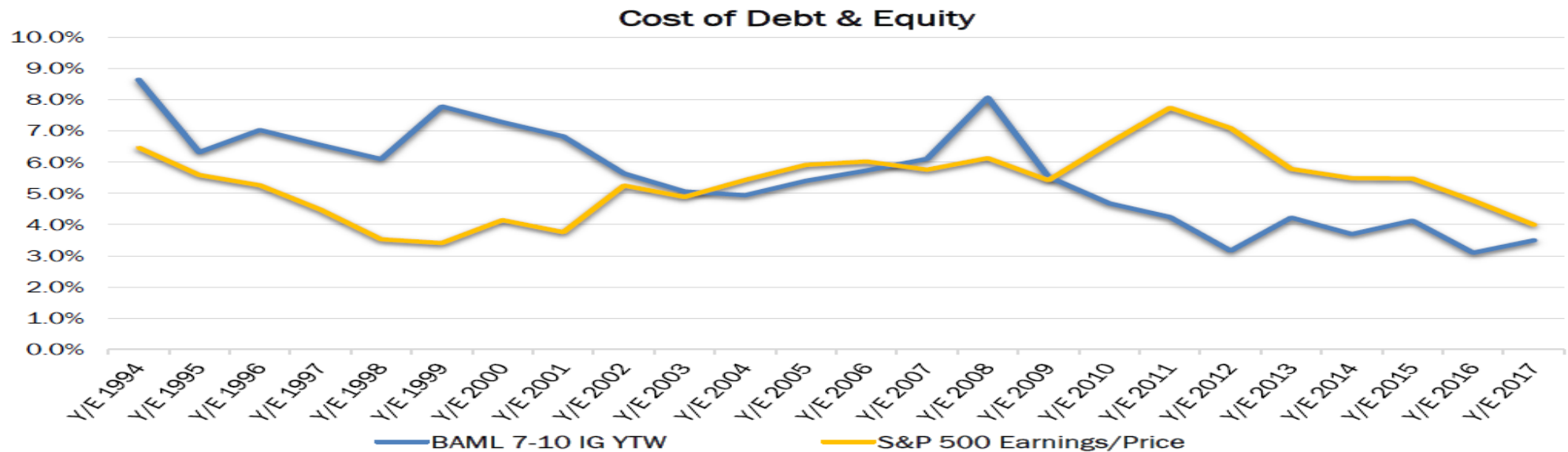
Corporate Profitability Back to Pre-Recession Levels



Since 3Q05 to current, a comparison of revenue per share for the S&P 500 index and the margin of earnings before interest and taxes. The chart illustrates revenue growth and margin expansion or compression.

Source: Bloomberg Data

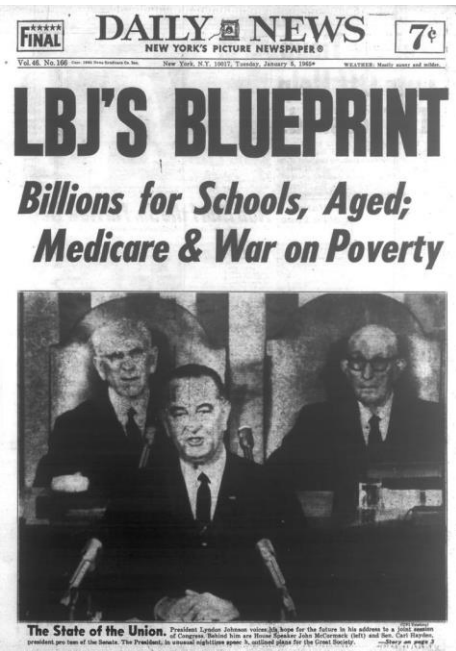
Stocks Vs. Corporate Bonds: Too Close to Call



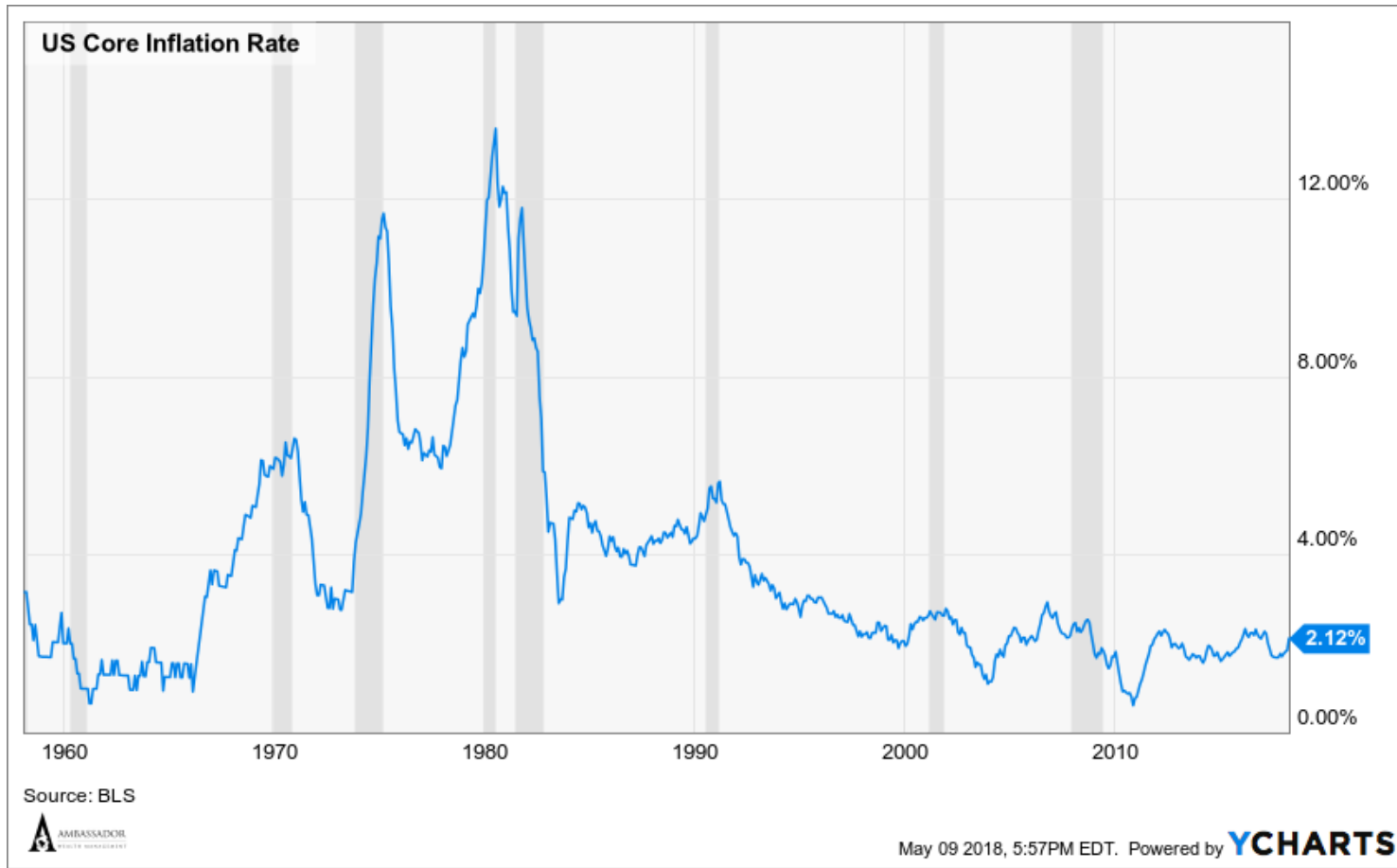
Since 1994 to current, a comparison of the S&P 500 earnings yield (the inverse of the P/E ratio) to the yield for investment grade bonds. The relationship is often indicative of peaks and troughs of financial engineering and corporate M&A activity. Interestingly, the S&P 500 earnings yield was consistently lower than 10 year US Treasury rates from the 1950s through 2000. Subsequently, investors have demanded a higher return on S&P 500 earnings yield to a 10 year UST. If one perceives a stock as a long term bond at the bottom of the capital structure in which the coupon is determined by their share of the corporate earnings, an explanation for the change may be investors view toward growth. Others may take the view that the earnings yield premium or discount spread to 10 year US Treasury reflects macro views of inflation or deflation. In many respects, both views are consistent.

Source: Bank of America Merrill Lynch Bond Indices, Bloomberg Data

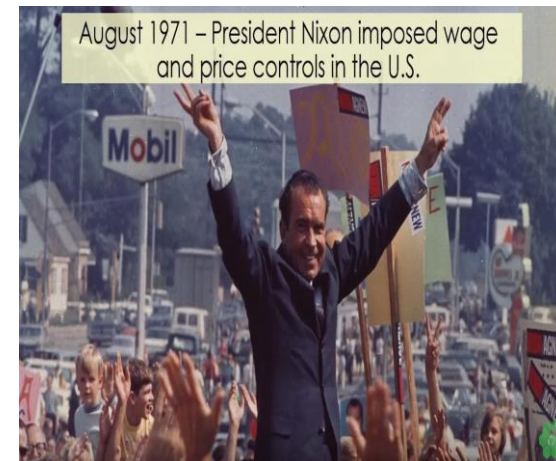
Inflation: Historical Perspective



http://assets.nydailynews.com/polopoly_fs/1.2063933.14202262291/img/httpimage/image.jpg_gen/derivatives/article_750/greatsociety03a-3-web.jpg



<https://media.npr.org/assets/img/2013/10/16/ap7306010161-043a4de622c4771515f2e3d9656073a15c9fee82-s300-c85.jpg>



<http://blog.acton.org/wp-content/uploads/2017/04/mru-418.png>

Inflation: Recent History of Depressed Numbers

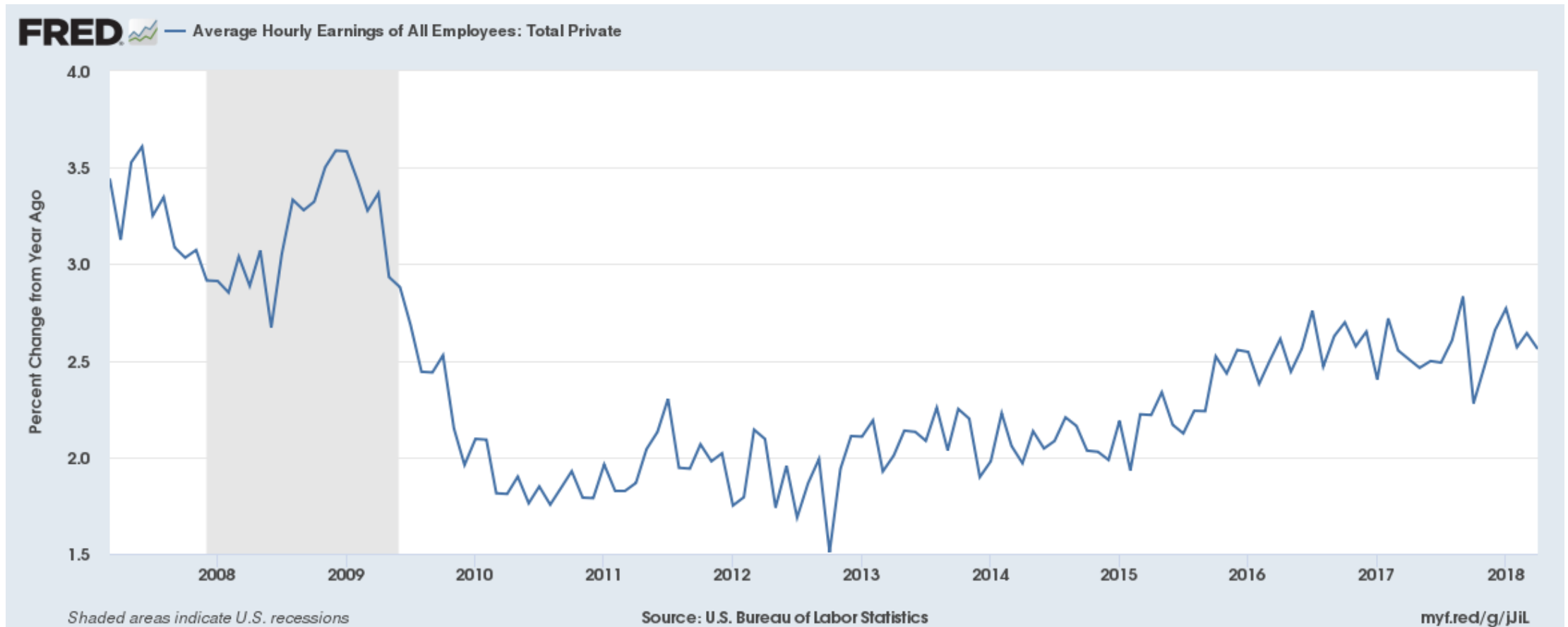


<https://chechatka.files.wordpress.com/2008/04/foreclosure.jpg>

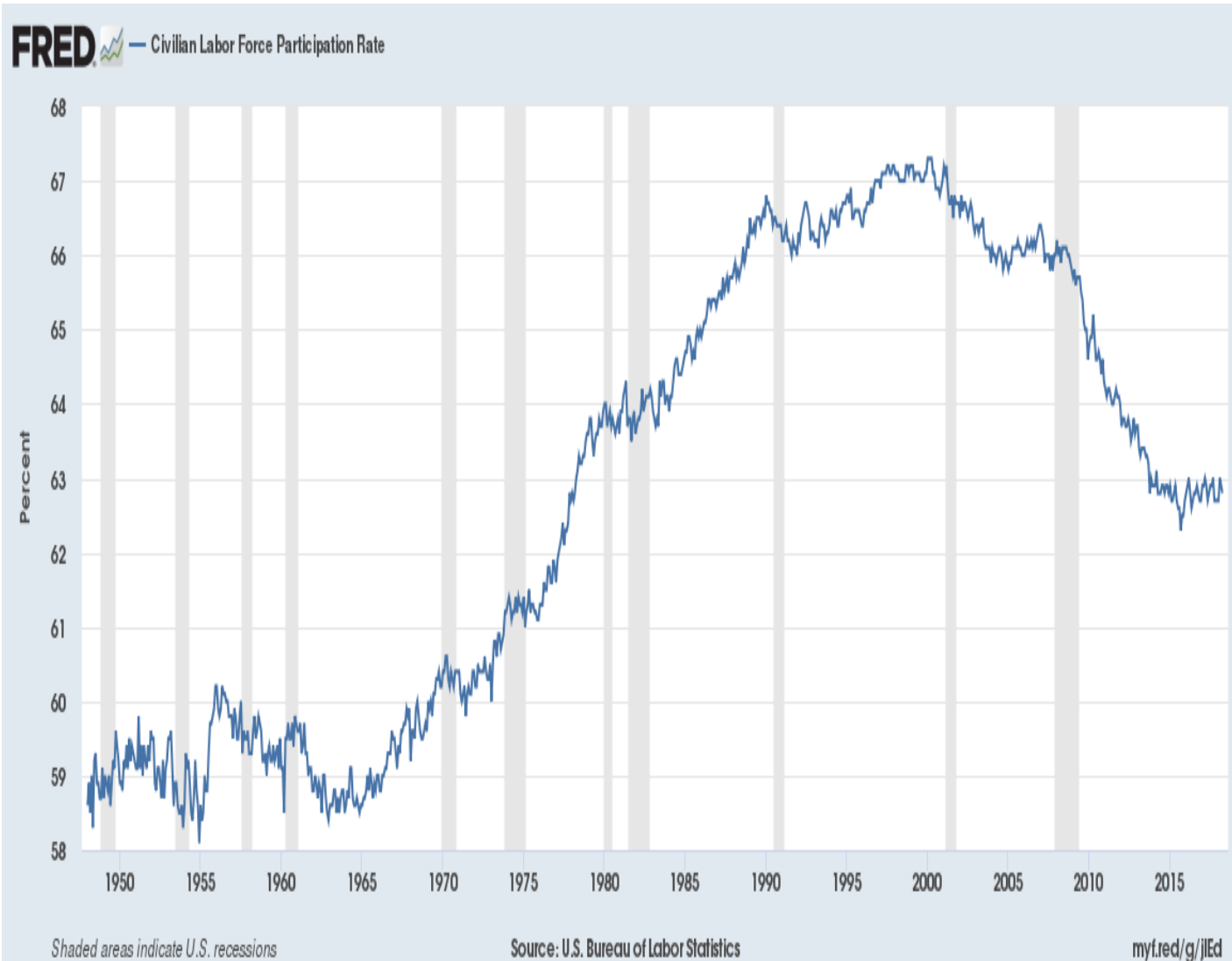


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Rising Wages: Return to Normal Inflation?



Labor Supply: Headwind or Tailwind?

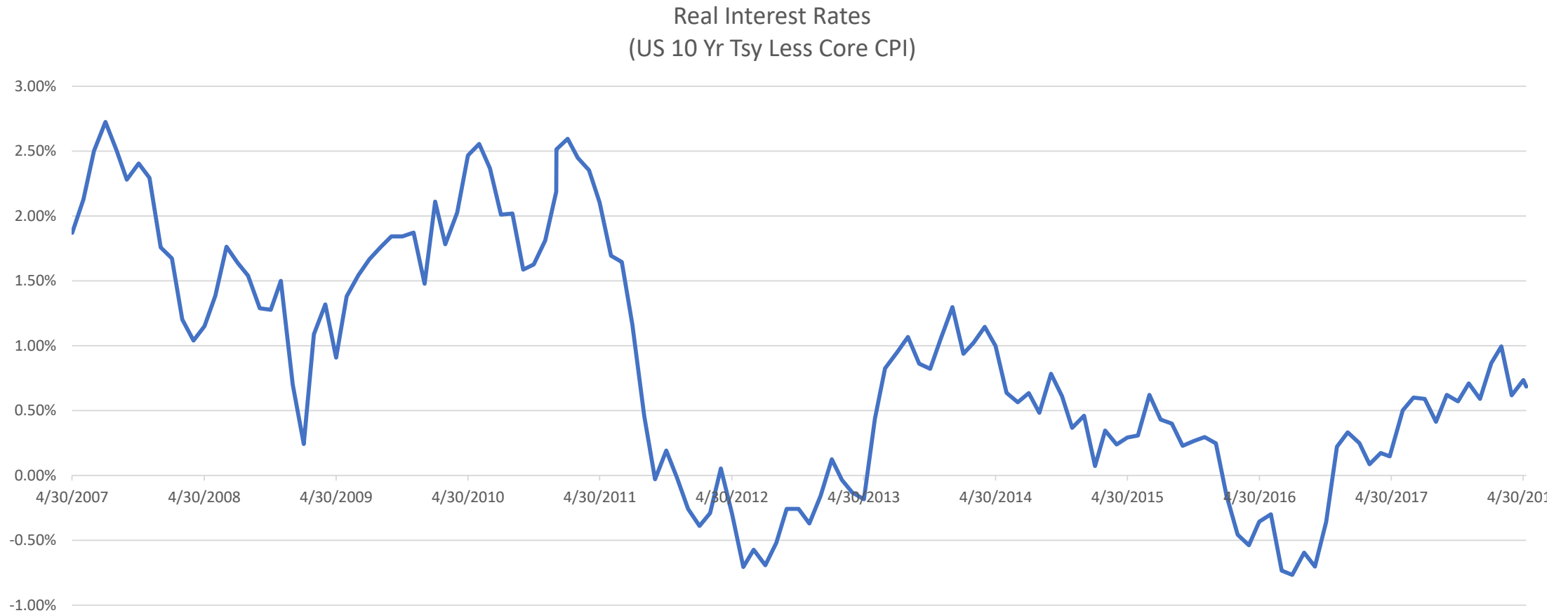


<http://arvadachamber.org/wp-content/uploads/2017/07/retirement-milestones.jpg>

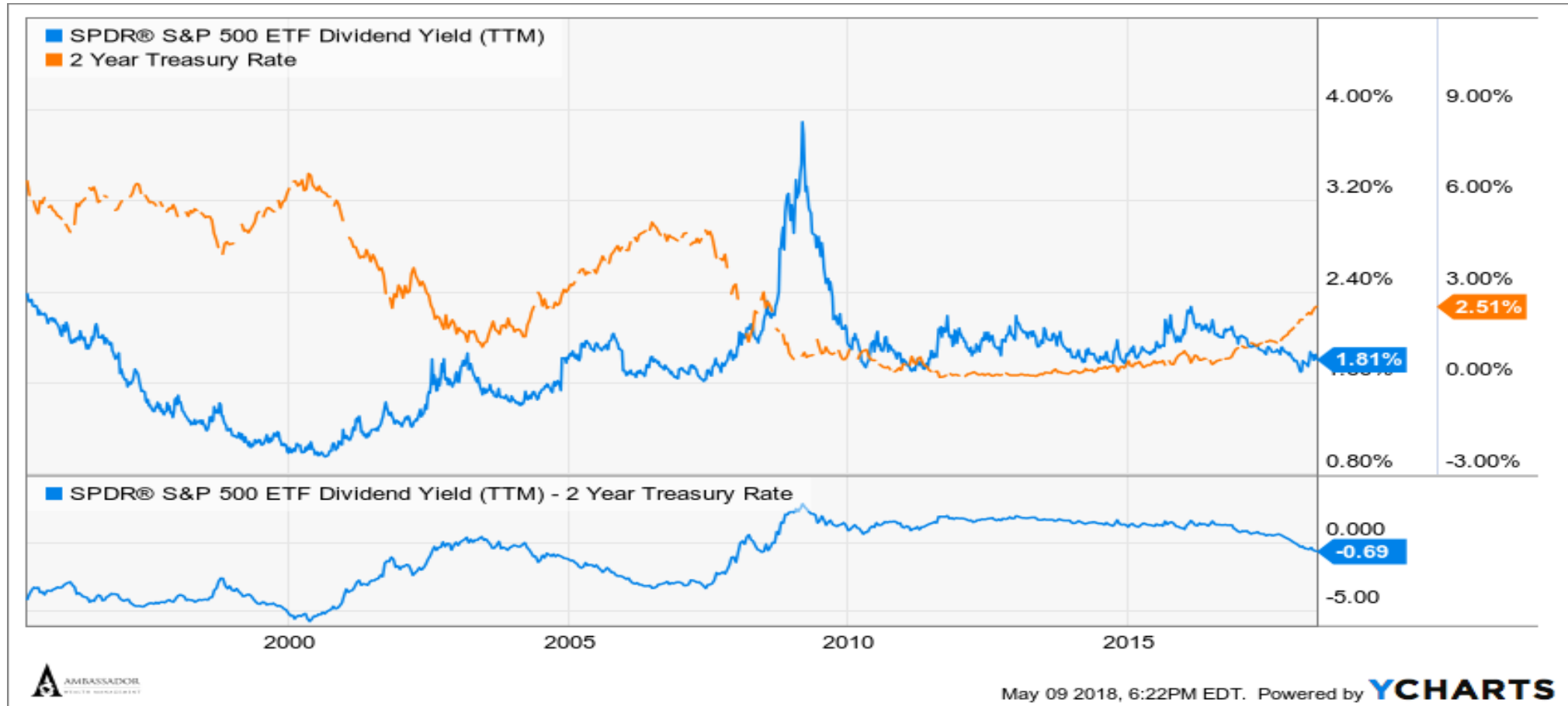


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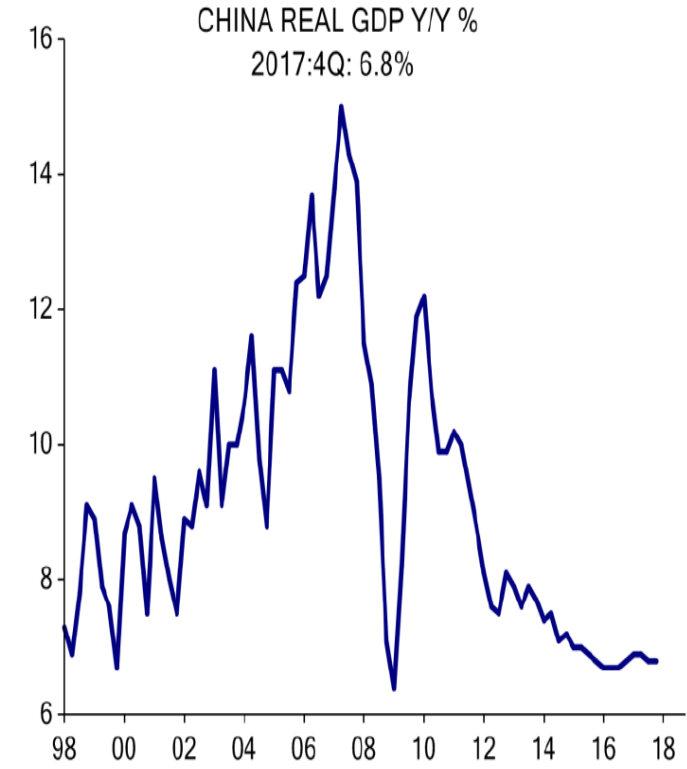
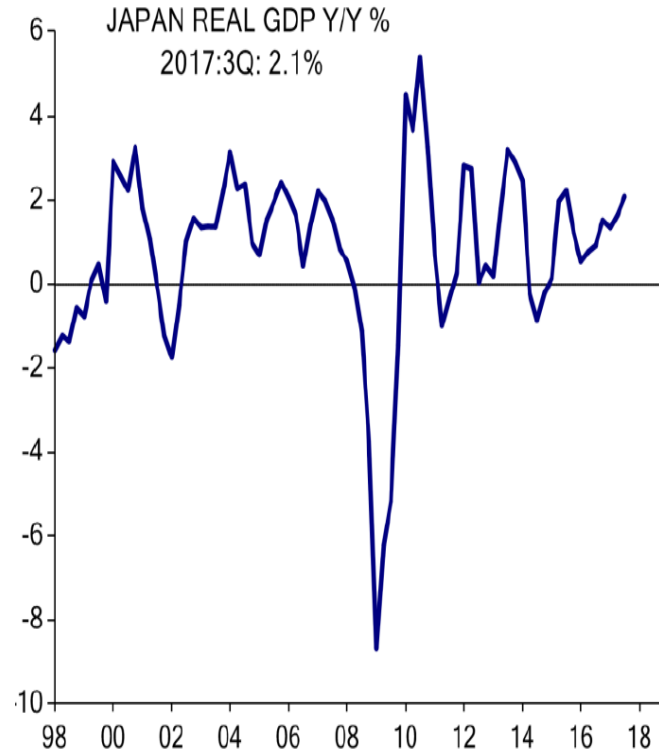
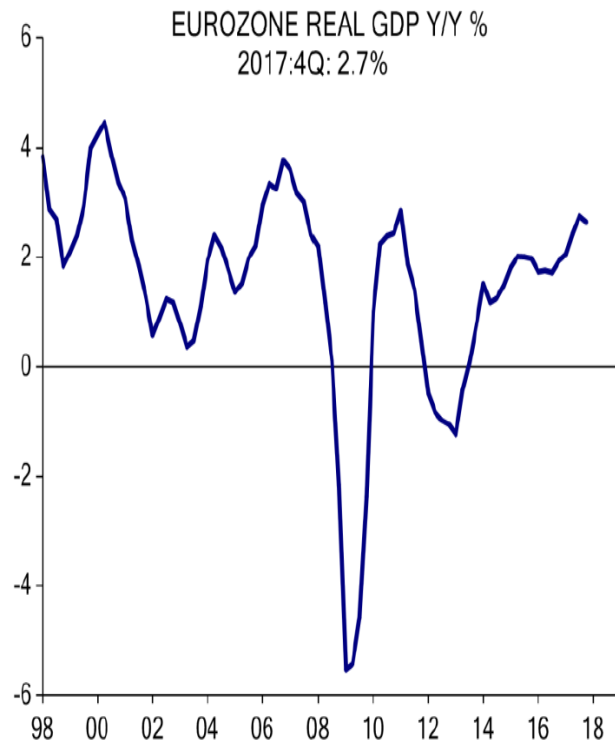
Bond Yields Have Room to Rise Even If Inflation Hardly Budges



S&P Might Handle More Good Economic News, But How Much Will the Fed Tolerate?



Growth Spreading Globally



Japan: Can the Sun Continue to Rise?



Source: Evercore/ISI Research.

Some Market Pundits Are Very Bullish

- *“A market surge is ahead. If you’re holding cash, you’re going to feel pretty stupid.”* Ray Dalio
- *“I recognize that we are currently showing signs of entering the melt-up phase of the bull market.”* Jeremy Grantham
- *“The game of economic miracles is in its early innings. The world is getting better.”* Warren Buffett

• <https://www.cnbc.com/2018/01/23/ray-dalio-says-market-surge-may-be-ahead-if-youre-holding-cash-youre-going-to-feel-pretty-stupid.html> accessed on February 2, 2018.

• <https://www.bloomberg.com/news/articles/2018-01-03/gmo-s-grantham-says-stocks-could-be-heading-for-a-melt-up> accessed on February 2, 2018.

• <https://www.bloomberg.com/news/articles/2018-01-04/warren-buffett-remains-optimistic-about-america-s-future> accessed on February 2, 2018.

Others Fear More Rocky Times Ahead

“Dimon Says Prepare for 4% Yields, Potential Volatility Rise”
Bloomberg Markets, May 7, 2018.



Not All Bulls Get Rewarded...

