COUNTER POINT

The Quarterly Commentary of Jurika, Mills & Keifer LLC

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In this issue:

To Scare a Clown

Many people are scared of clowns. They can be very creepy. A case in point is the clown in the movie adaptation of Steven King's "It," which features a particularly terrifying creature that feeds upon its victims' worst fears. Ironically, "It" was one of the top grossing movies over the summer.

It makes you wonder what clowns are scared of? Perhaps politicians and crazy world leaders? Like clowns, they often wear a painted smile on their faces for the public, but their actions can be far more frightening and consequential.

Currently, judging by box office results and market returns, moviegoers and investors don't

Summary:

- Despite scary geopolitical headlines, we have seen a pickup in global economic growth throughout much of the world, and especially outside of the US.
- Buoyed by low interest rates, these conditions drove stock markets higher in the third quarter, with non-U.S. stocks handily outperforming U.S. stocks.
- These trends are likely to continue a while longer, but are increasingly vulnerable to rising inflation, rising interest rates, and nasty surprises from left field. Meanwhile, given current valuation levels, most asset classes look fully valued, if not expensive.
- For this reason, we took steps to trim some equity exposure and reduce overall portfolio risk during the quarter. As always, we continue to balance investments targeted at areas of long-term growth with a core of defensive and alternative strategies.

seem overly scared of either, clowns or crazy world leaders.

Nor do investors seem currently rattled by hurricanes, credit scandals, Russian hackers, and most of the other headlines that dominate the daily news cycle.

This brings us to one of the questions that our clients have been asking us most frequently: ***"Given all the crazy stuff that is going on in the world, how come the stock market keeps going higher and higher and how long can this last?"***

We have two answers to this question. The first is a more generic nugget of wisdom we have learned over years of investing: ***things don't matter until investors decide that they do, and then they can matter a lot.***

The second related answer is that, for the time being, investors have decided to ignore most of the news and focus on current economic fundamentals, which are good and getting better.

The global economy is improving, monetary policy remains easy and interest rates are very low almost everywhere. This combination of conditions is driving the prices of risk assets higher around the world including stocks, bonds and real estate.

Since the end of the second quarter we have actually seen a marked pickup in coordinated growth around the world, and especially outside of the United States. This is a positive departure from recent years where the U.S. was in the lead in terms of economic growth and most of the rest of the world was floundering along or in recession.

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It is also worth noting that much of this pick-up in growth is organic, and not so much the result of artificial stimulus from Central Banks. If anything, the tide of extraordinary monetary policy by the World's Central Banks is ebbing.

In the U.S., the Federal Reserve has been moving to return to normal monetary policy by raising interest rates and starting to shrink its balance sheet.

The European Central Bank is likely behind the Federal Reserve playbook by several steps, but is also carefully moving in the same direction, back towards normal monetary policy.

Barring any near-term disruptions, we think the trend of global economic expansion should be self-sustaining for several more quarters. Although the current economic expansion in the U.S. is one of the longest in history, it has also been one of the slowest, and so we may have gained extra mileage in exchange for driving below the speed limit for so long.

There is also room for positive surprises. Unlike last fall, most investors now have very low expectations for any significant legislation from Washington including tax-reform, deregulation or infrastructure programs. So, if the President and Congress are able to actually do anything that is both significant and beneficial for the economy, it would be a positive surprise and likely provide an additional boost to the economy and markets.

Congress may have no choice but to pass a de facto infrastructure spending bill to help rebuild Houston, parts of Florida, the Virgin Islands, and Puerto Rico in the wake of Hurricanes Harvey, Irma, and Maria. This is a far departure from the original trillion-dollar plan to rebuild the nations decaying bridges, airports and roadways, but it will certainly be stimulative for the Southeast and provide a temporary boost to GDP.

The biggest and most likely risk to global growth is inflation and a sudden rise in interest rates.

In the US, the unemployment rate is now at 4.4%, close to a historic low level, and the supply of labor is getting tight, especially in industries like construction and technology. The incremental demand for labor in the Southeast to rebuild after the hurricanes will only make things tighter. Although we have not yet seen tight labor supply translate to meaningfully higher wages, this is a risk worth watching.

Some raw materials supplies such as lumber are also experiencing shortages and prices are rising. Measures to restrict immigration and trade are only making matters worse, creating bottlenecks in the economy that ultimately lead to slower growth and higher inflation (aka "stagflation") down the road.

The Federal Reserve and the bond market both are of the current opinion that inflationary forces will remain benign and that the Fed can take a slow and measured approach to normalizing monetary policy. An acceleration in inflationary pressures would change this calculation and likely cause the Fed to step on the brakes faster and more forcefully. It would also likely cause a sell-off in the bond and other markets as investors readjust their expectations.

In Europe, we are also seeing a rise in inflationary pressures as growth picks up. If inflationary indicators start to run too hot, the European Central Bank will need to accelerate its own time line for raising interest rates and making monetary policy more restrictive.

As we mentioned above, the pickup in growth is a global phenomenon and growth is accelerating faster outside the U.S. than within the U.S. This has translated to stock markets in the rest of the world finally outperforming the U.S. for the first time in five years.

These reversals of economic cycles and fortune are typically more than a one year phenomenon and we would expect these trends to continue at least into next year.

From a stock market standpoint, it would seem that the rest of the world still has a lot of catching up to do. Since 2012, while the S&P 500 is up 95%, the MSCI All Country World Index - Excluding the U.S. - is up only 32%, a third as much, and the MSCI Emerging Markets Index is up only a paltry 15%.

We don't believe in a complete reversion to the mean - the U.S. economy is of higher quality and deserves to trade at a premium – but the rest of the world currently offers slightly faster growth for a slightly cheaper price.

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Investment Strategy.

Another question that clients ask us is: "Are there any bubbles out there?"

If there is one, it is in the global sovereign and corporate bond markets where most government bonds are very overvalued relative to fundamentals. Despite the prospect of rising inflation, A U.S. ten year Treasury has a yield of just 2.3%. This seems irrationally low, until you consider that an Italian 10-year government bond yields 2.1%, a 10-year German bond yields 0.5% and a 10-year Japanese bond yields basically zero.

Corporate bonds are also expensive, with junk bonds selling at close to historically low credit spreads versus Treasury bonds.

By contrast, stocks look almost like a relative bargain. This doesn't mean stocks are cheap, but rather underscores that bonds are very expensive.

As long as corporate earnings and economic fundamentals continue to improve, markets should remain at or near current levels and potentially move even higher.

This is a more bullish outlook for the world economy than for the investment markets. We think that a lot of the good news is already reflected in market prices. At current valuation levels, expected returns are not especially attractive and additional gains will need to be supported by additional improvements in fundamentals.

A final question we are frequently asked is ***"Do you think we are going to have a correction?"*** Our answer to this question is always "yes."

There is typically a correction in the stock market every year, and if you have a long-term time horizon you will live through many corrections and recessions.

Corrections and recessions are a normal and healthy part of economic and market cycles. They wring out the excesses and help restore prices and fundamentals to a more stable footing for future growth and appreciation.

Although normal, they are hard to predict. Markets can remain elevated and overvalued for extended periods of time.

We are therefore quick to point out that it is typically foolish to try to time markets, and we know very few wealthy and successful market timers. We do know many wealthy and successful long-term investors.

Rather than trying to time markets it is a far better strategy to design portfolios to weather the inevitable storms that come along.

While we do not try to call market moves, we do look at the range of expected returns of the investments we make over the coming three to five years. Currently, with most global asset classes appearing to be fully valued, if not downright expensive, our future return expectations are low, and the symmetry of those expectations is skewed to the downside.

And so, despite the more positive economic backdrop, we think this is a good time to be modestly more defensive.

For this reason, we took additional steps during the past quarter to reduce some of our exposure to stocks. We moved the proceeds to the sidelines to be redeployed when investors are once again fearful, prices are lower and opportunities are more favorable.

We continue to invest with a global focus, balancing investments targeted towards areas of long-term growth and innovation, such as technology, life sciences and the developing world, with more defensive equity, alternative and bond strategies to mitigate volatility and risk.

As always, we welcome your comments, questions and referrals.

Jurika, Mills & Keifer, LLC
October, 2017

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Our objective is to preserve and build the purchasing power of our clients' capital over time through forward-looking investment management and smart financial planning and counsel.

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