3RD QUARTER 2016 UPDATE

October 10, 2016

Humanity spent the last 50 years globalizing. Now, thanks to certain technologies, that whole process is going in reverse. I think historians will mark the 2008 financial crisis as the turning point: Peak Globalization. I don't say this because I want a de-globalized world. What any of us want or don't want is irrelevant. I believe the transition will happen whether any of us want it to or not. It will not happen in a linear fashion, though. The process that brought us to this point had starts, stops and slowdowns. Reverse globalization will have ups and downs too, but a new set of technologies will keep pushing it forward.

World Gone Backwards, by Patrick Watson
From John Mauldin's *Thoughts from the Frontline* newsletter, August, 7, 2016.
http://www.mauldineconomics.com/frontlinethoughts/world-gone-backwards

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The stock market does not move in a straight line. Or, perhaps more accurately, the minute you think it is moving straight down or straight up, it reverses direction. Swings down from bull market tops and swings up from bear market lows are particularly illustrative of these reversals; in 2008 the S&P 500 stock market index dropped -37% and in 2009 the S&P 500 was up +26%. Given these types of swings it is easy to see why behavioral economists view the movements of the stock market over shorter periods of time, over months or even years, more as a reflection of investors' emotions than a legitimate assessment of underlying business valuations. There are times, however, when the stock market's movements do illustrate a more considered framework (at least in the eye of this beholder). In the weekly chart of the S&P 500 attached to this letter (Chart 1), I have inserted a box that encloses the action of the stock market over the last few years. In the middle of this past July, investors pushed the S&P 500 out of the top of that box. While it dipped back briefly during some Federal Reserve interest rate policy jitters in mid-September, it is perched just above the box as I write this. In a straightforward interpretation, above the box represents a bullish economic outlook by investors, in the box reflects a neutral or indecisive economic outlook and a movement below the box would reflect a decidedly bearish outlook. Right here, right now, the bullish outlook is asserting itself.

I remain impressed that the S&P 500 was able to avoid breaking down below the box during the last couple of years. Underlying business fundamentals peaked somewhere in the 2nd to 3rd quarters of 2014 when they were materially impacted by a surge in the value of the U.S. dollar and a collapse in the price of oil. Since that time, aggregate revenues and earnings of the S&P 500 have been trending down. Real (inflation adjusted) growth in U.S. Gross Domestic Product has dropped from 2.49% in 2014 to 1.88% in 2015 to 1.2% annualized in the first two quarters of 2016. When fundamentals trend down and the stock market moves sideways or up, the valuation of the stock market moves higher. Currently, as measured by a variety of metrics (the "price-to-sales ratio" and the "cyclically adjusted price-to-earnings ratio," also known as the "Shiller PE," to name two), the U.S. stock market is one of the four most expensive markets ever, including 1929, 2000 and 2007.

So what has helped hold up stocks?

1) "TINA" or "There is no alternative." TINA is the Wall Street acronym that compares the option of buying bonds with yields near historic lows (Chart 2) to buying stocks that give you at least a chance of making more money. For one day this past July, the yield on the ten year U.S. Treasury note dropped to 1.36%, marking the lowest interest rate an investor has ever purchased the note for in our history (the first debt of the U.S. was issued under Alexander Hamilton, our first Secretary of the Treasury and current Broadway star!). Overseas, in Europe and Japan, many trillions of dollars' worth of debt have negative yields -- yes, if an investor buys a bond with a negative yield-to-maturity, and cannot sell it to someone else for more than it was purchased for, he or she is guaranteed to lose money!

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2) Corporations continue to be the largest purchasers of their own stock (and are borrowing ever more money at low interest rates to support the purchases). In 2015, approximately $561 billion was purchased by corporations and the estimate for 2016 is running at roughly $450 billion.
3) Investors believe that U.S. economic growth and business fundamentals are starting to improve.

To be clear, I do not interpret the move of the S&P 500 above its box as a predictor of our near-term economic future (and though the global central banks may disagree, history tells us that positive stock market returns do not stop economic recessions from happening). To me the market's position relative to the box does present an unusually clear picture of investors' collective outlook and, as noted above, it is looking up. Given the valuation levels of both stocks and bonds, it also depicts to me a perspective that the stock market will move from an interest rate driven market to a revenue and earnings driven market – and that would be a refreshing development! That type of economic upturn would not only help support our clients' current investments, it would likely create new investment opportunities in some out of favor cyclical sectors that would benefit from higher commodity prices and/or an increase in capital spending. As a portfolio manager, Peak's job is always to evaluate the risks vs. the rewards of investments on both an individual basis and a total portfolio basis and, from that perspective, the move of the S&P 500 above its box is a bright and shiny reminder that investment discipline is ever more important the higher the stock market climbs.

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I don't know if I can exactly agree with the quote on de-globalization that I opened this letter with, but it is intriguing! While we may have passed some type of peak, for me globalization is more than what I perceive to be the author's narrow economic oriented thesis. In the article, he does acknowledge that innovations and technologies helped enable globalization but there were other factors that pushed it forward as well. Certainly, a post-World War II world viewed trade and direct investment as opportunities for positive engagement between countries. I believe that is still true today. The particular innovations that he cited as critical to opening the world to globalization included standardization of shipping containers, commercial jetliners, satellite communication and mutual funds as a source of pooled capital. On the flip side, in his case for de-globalization, he envisions continued development and adoption of technologies that help support independence from many of the major drivers of the current globalized economy, including renewable energy and battery storage to reduce foreign energy needs, 3-D printing and commercial-scale "additive" manufacturing that allows local flexibility and customization in producing a wide-variety of products, use of virtual reality and augmented reality technologies in place of travel, and the growth of local food production in any climate with cost effective, modern environmental controls. As an investor, when I look at globalization, I see that companies in the S&P 500 generate approximately 48% of their revenues from overseas trade and operations. These are smart and effective competitors who will continue to seek and develop new opportunities. And, while I do see the markets and businesses continuing to evolve with the impacts of new technologies, and I do see voter backlash to globalization on a variety of fronts, I believe that these de-globalization innovations could actually lead us to a more balanced form of globalization, particularly relating to the necessities of energy and food. That being said, there have been and will continue to be economic "winners" and "losers" as the globe and technologies progress. When I consider the current political rhetoric on globalization and trade, it is striking to me that none of these new innovations will bring back the jobs "lost to globalization." When I add robotics, artificial intelligence and self-driving vehicles to the mix, I conclude that our political and business leaders, and we as a country and as a world, need to spend time and energy figuring out how we can facilitate support, education and pathways to help people adapt and thrive. There are pros and cons to globalization and de-globalization – and I would like us to capture the best of both.

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We appreciate the trust that you place in us and we will continue to work hard to earn it. Please consider passing on our contact information to anyone you know that needs help in building and maintaining financial security. We are happy to share our perspective with them and to explore if there would be a good fit for working together.

John McCorvie, CFA

Chart 1: S&P 500 weekly chart through 09/30/16

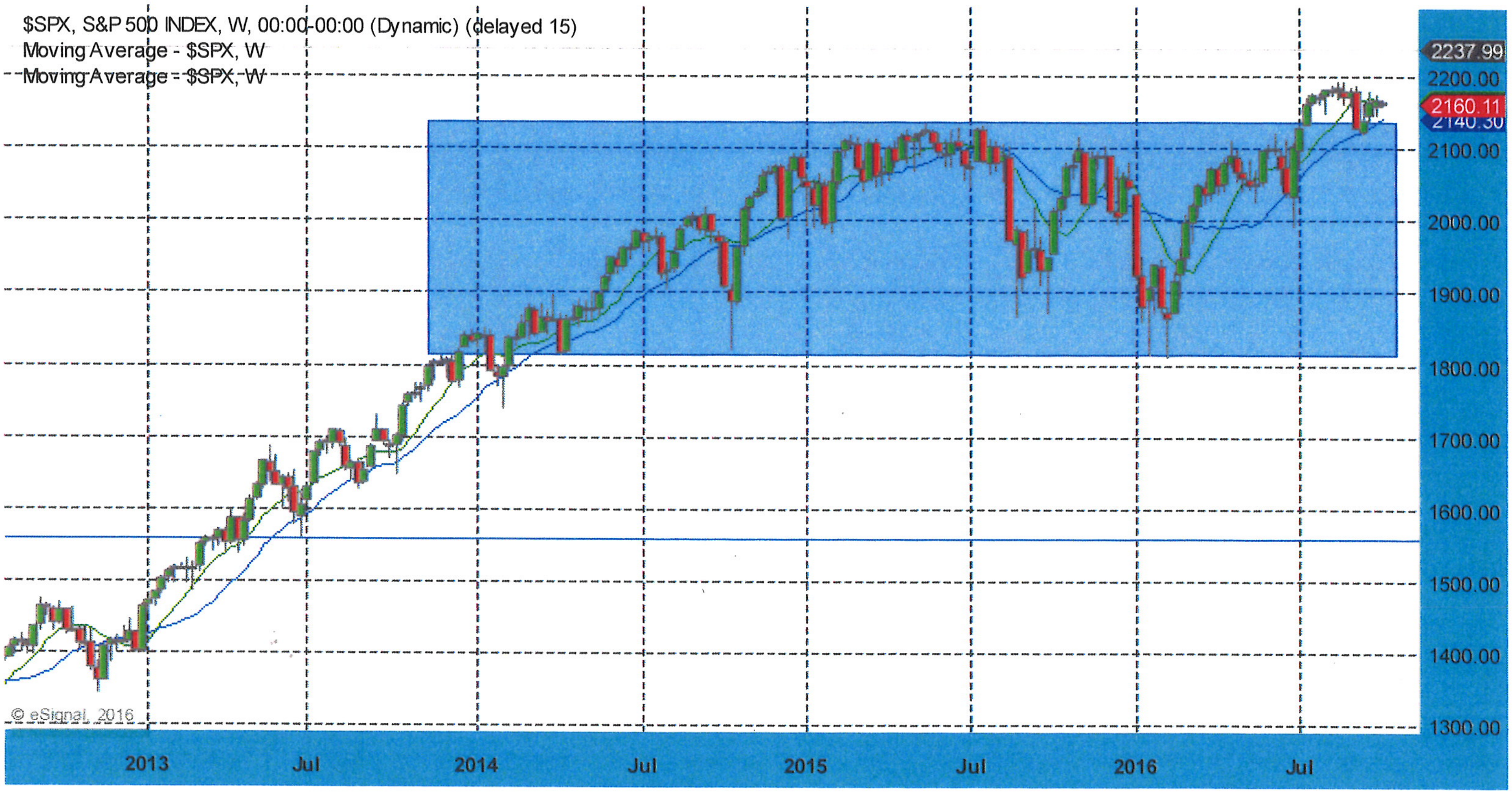

Chart 2: Ten year U.S. Treasury note yield through 09/30/16