La La Land

FC Advisors Quarterly Investment Update – Q1 2017

As many readers know, the 89th Oscars were awarded on February 26th. This annual celebration of Hollywood's enduring ability to be impressed with itself, was capped off with potentially the most interesting moment in the history of the Oscars. In case you missed it, "La La Land" was mistakenly awarded the Oscar for Best Picture, instead of the true winner, "Moonlight." The most fascinating aspect of this mix-up, beyond the obvious drama, was the ensuing 2 minutes and 29 seconds in which the world proceeded as if "La La Land" was the legitimate winner. The obligatory applause, handshakes & hugs, were followed by heartfelt acceptance speeches. It was a completely real & authentic experience – until it wasn't. Suddenly, in the "Moonlight Moment", everyone was surprised to discover that their real emotions were based on a false premise.

We can't help but find this Oscars moment instructive for the current investment environment in the US. In fact, our opinion is that the US stock market is in La La Land today. We define La La Land as the point beyond maximum rational optimism and just at the beginning of irrational optimism. Investors seem infatuated with the opportunities that deregulation, tax reform, infrastructure spending and ~~healthcare reform~~ will bring to the US economy. From our vantage point, it appears that the market has chosen to ignore the fact that all policies have both positive and negative ramifications. While it may be frustrating to some, there is no reason that the market cannot continue marching higher into ever-increasing irrational optimism. The word, irrational, literally means without reason. Therefore we must accept that the market no longer needs "reasons" to justify ever-higher prices. The lesson from the Oscars debacle, for all investors, is that even though the US stock market may continue moving irrationally higher, your emotions will be real. It will be a completely real & authentic experience – until it isn't. We are confident that the US stock market will experience its own "Moonlight Moment", which will be when we all realize that the thrills of making more money and the regrets of missing out were based on a false premise.

Executive Summary

- The Quarter in Review
- Sentiment & Value Update
- Themes We're Still Watching
- Inflation
- Straight-line Thinking

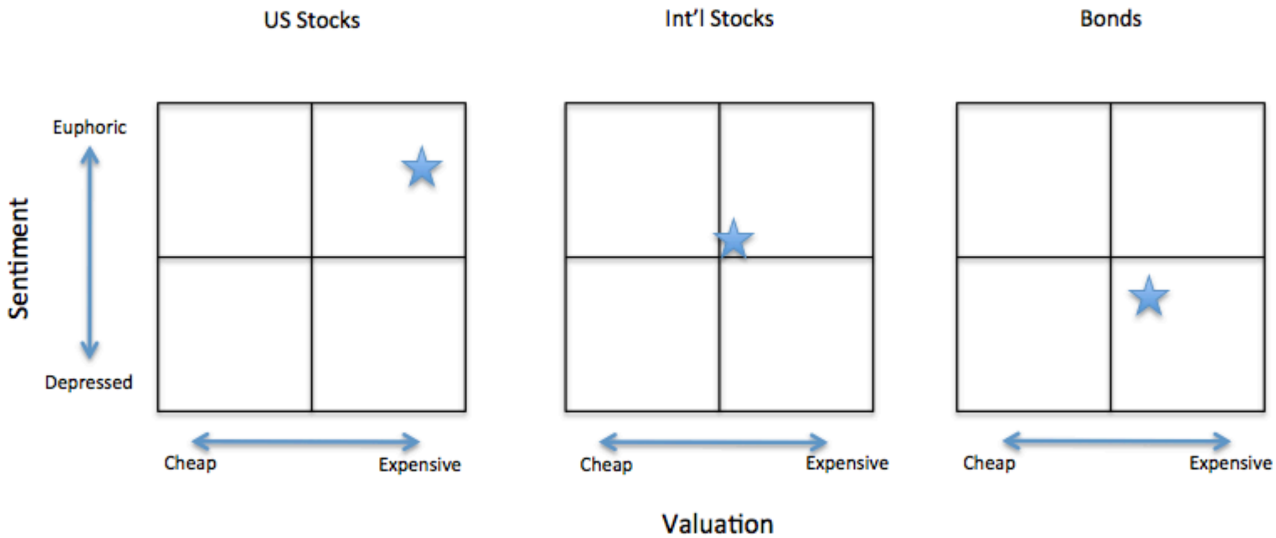
The Quarter in Review

Politics once again dominated the news in the 1st quarter of 2017. The US stock market continued to rally until peaking recently on March 1st. The bond markets stabilized after selling off on expectations of higher inflation and faster economic growth. Gold recovered most of its post-election losses and international stock markets outperformed the US stock market for the first time in a while.

Relevant Index Performance

	Total Returns as of 3/31/17	
	Qtr to Date	Last 12 Months
S&P 500	6.07%	17.17%
MSCI World ex-US	6.95%	12.52%
MSCI Emerging Mkts	11.49%	17.65%
S&P Municipal Index	1.41%	0.55%
10 Year Treasury	0.79%	-2.41%

Sentiment & Value



The chart above shows our opinion on where various markets are as of March 31st 2017. Many of the best purchase decisions are made when prices are cheap and sentiment is bearish or depressed (bottom left quadrant). Conversely, many of the best sell decisions are made when prices are expensive and sentiment is bullish or euphoric (top right quadrant).

	US Stocks	International Stocks	Bonds
Sentiment change in last 3 months	Sentiment hit very high levels at the end of February. There is a growing gap between the perceived strength of the economy and the actual hard data.	More bullish. The political crisis in Europe is simmering instead of boiling.	Slightly more bullish. Investors are warming up to the possibility that the new president may bring less change than advertised.
Value change in last 3 months	More expensive - prices rose with little improvement in earnings or economic growth. Valuation ratios of all sorts are very high.	More expensive - prices rose, but so did earnings and GDP growth. Weakening US dollar has also helped boost performance.	Slightly more expensive - prices rose (and interest rates declined). Inflation risk is now more accurately priced
Signal	Sell	Neutral	Neutral
FC's Take	We are still enjoying the rally, but are in the process of gradually reducing US stock positions.	The best place to look for equity investments, we just wish it was cheaper.	A small buying opportunity in the bond market has closed.

It appears that "the bloom may be coming off the rose" for the Trump administration as the challenges of governing a severely divided country begin to re-emerge, but it is still too early to tell if US stock market sentiment has peaked. We still see stock markets around the world as broadly too optimistic about economic growth. In the bond market, investors receive only a small opportunity to grow their wealth after accounting for inflation. We do not believe that we can call the top of the market (or the eventual bottom for that matter), and for that reason we will continue to stick to our discipline of gradually adjusting portfolios based on the opportunities the market gives us. If the stock market continues to rally, we will continue to gradually reduce our exposure and add to positions that can help insulate portfolios from the major risks we see. *All things being equal, if the S&P 500 were to trade below 2000, we would be more comfortable buying US stocks and if the 10-year treasury yielded more than 3.00% we would be enthusiastically buying bonds.*

Themes We Are Still Watching

We've mentioned lots of issues and themes in these letters. Just because we aren't writing about them every quarter, does not mean we have forgotten about them. We continue to track these issues as they evolve and adjust our portfolios accordingly.

Risk/Opportunity	Major Theme(s)	Potential Surprise	FC's Position
Public Sector Pensions	*Debt & Demographic challenges	*Underfunded pensions suddenly matter	*Expect slower economic growth *Deflation risk, good for government bonds
Brexit, European Elections, Protectionism	*Waning globalization	*Europe is less united than people think *European banking crisis	*While the near-term risks in Europe have receded, the root causes are continuing to fester. We are avoiding Europe.
Japanese stocks valued in US dollars	*Overactive central banks *Debt & Demographic challenges	*Global financial system is more fragile than people think	*Prices are up, but still an attractive hedge against global financial instability
Gold & Gold Miners	*Overactive central banks *Waning globalization	*Global financial system is more fragile than people think	*Cheaper than when we first wrote about them, more upside now *Good hedge against global economic instability

Inflation

Issue: Since the election of Donald Trump, the financial media is convinced that inflation will move persistently higher, benefiting workers and encouraging US economic growth.

Impact: Higher inflation generally hurts bond prices because it pushes up interest rates (higher interest rates = lower bond prices). The impact on stocks is less beneficial than commonly thought. Rising inflation generally encourages customers to spend money now, rather than waiting, which generally helps businesses. However, the largest expense for most companies is labor. If rising inflation increases the cost of labor, it often means less profit for the company. For workers, as long as their wages rise faster than the cost of living, rising inflation can feel good. Rule of thumb: if inflation comes too suddenly, it is bad for everyone.

FC Advisors Position: Inflation statistics are tricky. It is important to understand that inflation is a rate of change, like acceleration or deceleration. Because we all have a limited amount of money, it is hard for prices to keep moving in the same direction at an ever-faster pace. In other words, when gas gets really expensive we respond by driving less, eventually pushing the price back down.

We find that there are three general categories of inflation. Knowing which one we are experiencing helps us determine the risk we face. The table below summarizes the role each of these categories of inflation plays in the US economy today. We see the threat of rising inflation as low today because most of the inflation in the economy appears to be either transitory or unsustainable.

	Transitory	Unsustainable	Self-Reinforcing
Description	One-time changes in price that are unlikely to happen again	Changes in price that ultimately short-circuit themselves	Rising prices that lead to even more rising prices
Example	*Change in oil price from Jan 2016 ($29.27) to Jan 2017 ($52.97). US oil producers are steadily increasing their drilling & pumping activities, thwarting OPEC's efforts to boost prices more.	*Rising rents without rising wages, such as we are seeing today *Dramatic rise in oil prices without rising wages, such as 2008. *Dramatic rise in healthcare costs without rising wages.	*Rising wages in the 1970s, allow companies to raise prices, leading workers to ask for higher wages, and so on…
Current impact on US inflation?	Skewing higher: 81% inflation rate on oil, this will gradually decrease to 0% or even lower if prices remain stable for the next year.	Skewing higher: Rent, healthcare & education have all been rising faster than wages. Eventually this must stop or even reverse.	Flat or slightly negative
FC's Take	The recovery off of the panic lows in early 2016 is skewing inflation high today. We expect inflation statistics to trend lower from here.	We are watching wage data closely for signs of acceleration. So far it continues to look like shelter, healthcare and education inflation are unsustainable.	Wage growth has accelerated in the US, but more slowly than most other major costs of living. **Without equal or faster wage growth, transitory & unsustainable inflation eventually lead to recessions.**

Straight-line Thinking

Issue: The human brain loves to find patterns. This is part of the reason why we love information that comes in threes. Two data points in time shows us a trend. If a third data point confirms it, then we can predict the future by extending the line. In behavioral finance this is known as "linear extrapolation" or straight-line thinking.

Impact: Because we love patterns so much, it is very hard to ignore them. When we see patterns we instinctively try to find reasons to explain them. While these explanations may make sense, many of them are invalid. The more logical stories we create to explain a pattern, the more durable that pattern or trend appears. Investors often incur their biggest losses (and miss their biggest opportunities) when they forget that most trends, especially extreme trends, eventually reverse.

FC Advisors Position: It takes discipline to combat the urge to bet on straight-line thinking. Ultimately straight-line thinking is an uninformed, but very seductive, way of predicting the future. Particularly with limited information, investment rationale supported by patterns is hard to resist. For this reason straight-line thinking has become one of the most effective sales tools for financial sales people, particularly financial advisors and asset management firms. Helping everyday investors avoid these pitfalls is one of the core missions of FC Advisors. Avoiding straight-line thinking requires keeping an open mind and constantly looking for facts & data (particularly those that challenge our assumptions) to inform decision-making. These facts & data help us build an investment thesis for each of our investments. This discipline helps us buy more when prices fall and sell when a thesis begins to breakdown or a price gets too high. While this approach may mean missing out on some opportunities that we don't understand, it builds resilience that allows us to take advantage of the chaos that broken patterns cause. Straight lines and plausible stories make investors *feel* good because they create an illusion of predictability and stability around financial markets that actually does not exist.

More often than not, these illusions of predictability and stability are at the core of the false premises that take hold in La La Land. But as the "Moonlight Moment" taught us, history does not always unfold in smooth straight lines because things are not always as they seem.

If you have questions about these topics or any other financial needs, please contact FC Advisors at:

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