KWAG May Update

Good Afternoon! We hope you're enjoying this incredible spring weather up and down the east coast. This year the redbud and dogwood blooms have been brilliant in Asheville, NC. I can't remember the last time we've seen this type of color and brilliance. Of course, I also can't remember the last time we had this type of a brutal winter. If you're a gardener, you know brutally cold winters are often followed by brilliant spring colors. It's what keeps me (and other gardeners) going when the wind blows and the temperatures dip during the winter. We know there is a direct relationship between the brutal winter weather and the brilliant spring colors that follow.

Thankfully, this relationship does not exist between the US Economy (or GDP) and the stock market. Last Wednesday (April 29th), we learned that the U.S. economy grew at a relatively anemic 0.2% annualized rate in the first quarter. This was a sharp decline from the prior few quarters, when gross domestic product (GDP) grew by more than 3%. And, it was the weakest performance since the first quarter of last year (2014), when GDP actually contracted year-over-year.

The pattern of weak first-quarter data should not have been unexpected, since the first quarter has been notoriously weak when we look back over the last twenty to thirty years. Over that time period, first quarter GDP has averaged less than 1%, while the remaining three quarters average more than 3%.

The Media

Typically, after the quarterly GDP is reported, numerous articles can be found discussing the figures as well as what they might mean to investors. Similarly, the financial news networks interview numerous market pundits soliciting opinions about the recent data. This leads to natural questions from our clients, who wonder what an anemic first quarter means? While such data is interesting, as a general rule, it does not materially impact any of our long-term investment decisions, since we know GDP has no real direct relationship to long-term market

returns. Of course, we are not alone in our view of this relationship. At this past Saturday's shareholder meeting, Warren Buffett said the following when asked about the weak GDP and economists:

"Any company that has one economist has one employee too many."

Some might be surprised by this view. However, it is important to remember that the stock market is not driven by the US economy alone. For example, in a recent article, author Larry Swedroe showed how China and the US demonstrate this interesting disconnect. He found that over the five-year period between 2010-2014, economic growth in China averaged 8.5%, which was more than four times as fast as the US growth rate of just under 2%. From the outside looking in, you would think the Chinese stock market went crazy, while ours was muted. In fact, the exact opposite occurred.

During the last five years, Chinese stocks (as measured by the most popular China ETF: FXI) grew by less than 2% annually. This was in sharp contrast to the 15% annualized growth investors in US stocks realized over the same period (as measured by the S&P 500). During the same time period, the growth rates of economies of the US and UK were basically the same at around 2%. However, UK equity investors earned 6.3% annually (as measured by an ETF intended to capture the performance of the UK market: EWU), easily lagging the S&P500 annual 15% gain. So, you may be wondering: "If GDP and stock market returns are unrelated, what drove that significant difference in returns across countries?"

The Price

Clearly, there are a number of things that drive stock market returns over time. However, in a global economy, the primary determinant of future returns comes down to the "price" you pay for the current and future cash flows (or profits/earnings). This is why we have devoted many of our newsletters and updates to items that affect future cash flows, profits and P/E ratios.

Five years ago, if you examined the P/E ratios of Chinese stocks, you would have seen that they were trading at a significant "premium" to their long-term average. So, even though their economy was expanding at a significant rate, you would have been overpaying for those stocks given current earnings and prices. Conversely, the US had just experienced a significant sell-off. Therefore, the price you paid for earnings in the US was at a significant "discount" relative to their long-term average. Of course, the Federal Reserve was also beginning the first of their many quantitative easing (QE) programs, which is why we were so bullish on the stock market. We knew QE would lead to increased earnings and cash flows. In the UK, prices were "fairly" valued, but the Bank of England failed to stimulate their economy, which ended up muting their future earnings and cash flows.

The Federal Reserve

In the past, it was easy to figure out when stocks were under-valued or over-valued. You simply looked at the current price and compared the price to current and future (expected) earnings. If prices were above the longer-term P/E ratio, you knew the overall market was overpriced. If prices were below the longer-term P/E ratio, you knew the overall market was undervalued. Today, P/E ratios (for the entire market) are fairly valued given the current level of interest rates. This is where things get complex…

Five years ago, the Federal Reserve began manipulating short-term interest rates by increasing the money supply, just as they have for a number of decades. What makes this period different, is the Federal Reserve also engaged in a number of innovative strategies to manipulate long-term interest rates as well. This new twist (on long term rates) has worked so well that the rest of the world (which includes over 20 different central banks) has engaged in the exact same manipulative process. Unfortunately, this process is creating a number of unknown bubbles that will eventually erupt much like an earthquake. We know where some of the fault lines exist – interest rate sensitive bonds, certain stock sectors, Muni bonds and a number international markets – we just don't know when or how big the eruption will be. Of course, we also have no idea what will trigger the eruption.

In Sum

Today our financial markets sit at a very interesting crossroads. On one hand, corporate America has pristine balance sheets, wads of cash and a number of macroeconomic trends that provide a nice wind at their backs. This bodes well long-term, particularly when you factor in the effect of new technologies on virtually every industry. On the other hand, we know interest rates have to move back to more normal levels in the short term, which implies many areas of the stock market may be mispriced on the upside. Since we have no clue when interest rates will increase and we have no clue how those increases will affect many of the higher priced sectors of the market, we feel it's best to build well-diversified portfolios across the entire stock market and pro-actively rebalance.

As we go forward, investors will be challenged to make sense of anemic GDP's, higher than normal unemployment rates, and larger than normal deficits. In the past, those data points meant something when it came to stock market valuations. Today, interest rates, the Federal Reserve policy and macro-economic trends are much more important. The only important statistic that never changes over time is "PRICE". Thus, the most important takeaway is that value matters. It is best to buy low and sell high. As a general rule, the higher the price-earnings ratio is when you buy a stock or a market index, the lower the return is likely to be over the next five-to-ten years. This is precisely why we examine and maintain well-diversified portfolios that are pro-actively rebalanced into relatively underpriced areas of the market.

In essence, valuation is a key part of the KWAG investment process.

Thank You

As usual, if you have any questions about this update, our newsletter, your accounts or our managers, please feel free to call or e-mail us at any time. The recent referrals are much appreciated and we thank you for your continued confidence in our firm and our services. If you need anything or your goals or time horizons have changed, please do not hesitate to call or drop an e-mail to set up

an appointment. We are here to serve your financial needs, whatever they may be.

Piper & Kate

For those of you who are interested in how Piper and Kate are doing…here is a short update. They turned 12 weeks yesterday and will be a full three months on Saturday, the 10th. They are growing like weeds, eating like crazy, making funny noises and developing the cutest little personalities. We love them so much and can't wait to experience all the adventures (both good and bad) associated with parenthood. Thanks again for the caring e-mails, texts and calls. If you text me at 828-350-8681…I will text a picture back.

- ***Joe & The Gang at KWAG***

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