Third Quarter 2017 Review and Outlook

"Only when the tide goes out do you discover who's been swimming naked."- WARREN BUFFETT.

The third quarter of 2017 was another positive one for the U.S. equity markets, continuing a trend that has persisted since the 2016 election. The widely followed S & P 500 Index produced a total return of 4.5% for the quarter and has now gained 14.2% for the first nine months of the year. Importantly, volatility has remained exceptionally low with the market not having had a correction of more than 3% since the election. Looking at the year-to-date, information technology has led the market while telecom and energy have been laggards with small declines.

In a broader sense, growth stocks have significantly outperformed value stocks, extending their streak that began with the recovery from the Great Recession of 2008-2009. The current focus on growth stocks, in general, and a few notable ones in particular, such as the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) is cause for concern. In many ways, these stocks are priced for perfection and reminiscent of the "nifty fifty" stocks of the late 1960s and early 1970s. At that time, these entities were also called "one-decision" stocks because they could be purchased and held forever. Among those heralded stocks were: Eastman Kodak, Polaroid, Sears, Xerox and Simplicity Patterns. In essence, trees don't grow to the sky and nothing lasts forever. The darlings of today may not exist or be recognizable in the future.

Before moving on to the U.S. economy, a few comments are warranted about the VIX, a measure of market volatility often referred to as the "fear gauge". The VIX at its recent all-time low is <u>not</u> a forecast of what investors think about the future but how investors view the current market environment. Clearly, the VIX indicates that investors have no fear and, in fact, have become complacent believing that what is currently happening in the market will continue forever.

Against this performance, the U.S. economy has endured the slowest economic recovery since World War II. The subpar GDP growth rate has defied all efforts to return the economy to better than 3% growth rate which had been the norm for decades. Among other things, it appears that the consumer sector has been negatively impacted by anemic income growth, a low and declining savings rate and a Federal Reserve policy that is becoming more restrictive as it raises short term interest rates and begins a process to shrink its balance sheet.

While the 2016 election brought the promise of changes to the Affordable Care Act, a reduction in governmental regulations on the business community, a major rewrite of the outdated and antiquated income tax code and a major infrastructure program to address the needs of crumbling highways, failing bridges and transportation facilities, nothing of significance has been accomplished with respect to these major issues. Nevertheless, the markets have pushed higher based upon growing corporate profits and an economic expansion that has gradually spread around the world.

As the equity markets are assessed, it is hard to claim that valuations are reasonable. Currently, the S & P 500 Index is selling at 25 times trailing 12-month earnings compared to a long term average of 15 times earnings. The unique Shiller CAPE (cyclically adjusted price-earnings) ratio is about 30 compared to an historic average of 16. This current level was exceeded only in two years – 1929 and 2000, both of which were clear stock market bubbles. One further thought on the P/E ratio is that while the P is certainly inflated, the E has been enhanced during the last several years by massive cost cutting, stock buybacks and other such measures. In essence, the P/E may be understated and when earnings normalize, the P/E could be even higher than indicated by the raw numbers. Lastly, there is the "Buffet" measure of the market that computes the total U.S. stock market capitalization as a percentage of the U.S. GDP. Recently, this measure was approximately 145% which is significantly higher than the 1970-95 norm of roughly 60 and a 1995-2017 average of 100.

Looking ahead to the remainder of 2017 and into 2018, one of the areas of increasing concern is the U.S. budget deficit. Importantly, the U.S. federal debt increased \$3.7 trillion during the three years ending September 30, 2017 and is now in excess of \$20 trillion, approaching 110% of GDP. At the end of 2016, this ratio was 106.1%. Various studies have suggested that such high debt levels reduce the GDP growth rate and one study determined that when the debt ratio was over 90% for five consecutive years, the economy loses one-third of it long term trend rate of GDP growth. Significantly, U.S. government debt has exceeded 100% of GDP for each of the last six years.

Before closing the first quarterly letter from Metis Value Partners, LLC, a few comments are necessary about the rising popularity of ETFs in the investment world. As investors became cost conscious regarding investment management fees while also being disappointed in the investment returns from their professionally managed portfolios, Wall Street answered the call and promoted ETFs to mimic just about every known index plus many other heretofore unheard of ideas. Although ETFs have many attractive features, they also expose naïve investors to unknown risks. For instance, an investor who purchases an information technology ETF is content knowing that the portfolio will mirror that index in both up and down markets.

However, as more investors flock into that sector of the market, the ETF will continue to purchase shares of each stock in the index regardless of valuation.

In other words, while a professionally managed portfolio might curtail the purchase of some of the IT stocks due to their excessive valuation levels, the ETF will continue to purchase those stocks and the higher the high flyers rise, the more of that stock will need to be purchased. In brief, this is the exact opposite of Wall Street wisdom that says: "Buy low and sell high". In sum, ETFs are interesting vehicles that can be used selectively but investors need to be cognizant of the risks.

In conclusion, given the likelihood of sluggish growth over the foreseeable future, there is reason to believe that the equity markets will eventually undergo a correction to align valuations with economic reality. Keeping in mind that value stocks have underperformed their growth counterparts for a significant period, it would not be surprising to see value stocks come into vogue once again. Within this environment, it is prudent to remain steadfast to our beliefs that the purchase of high quality stocks of companies that are selling at a substantial discount to their intrinsic value will minimize risks and produce long term results that will be pleasing to our valued clients.

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