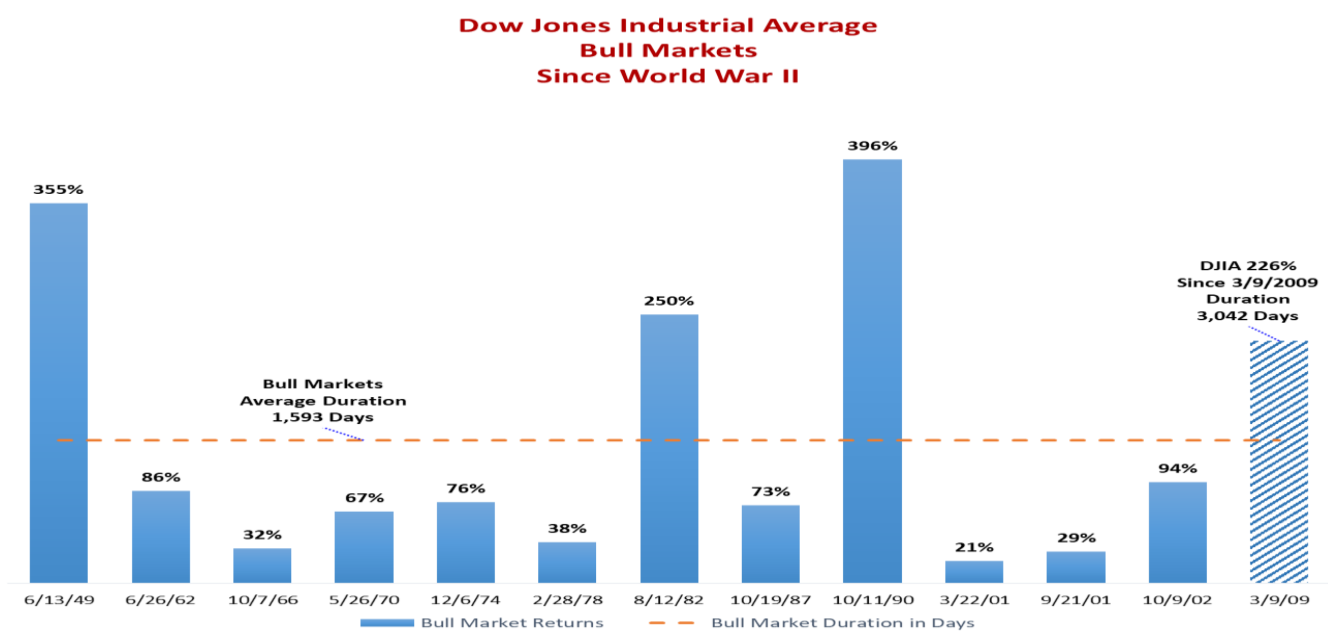
Three Market Threats

William "Chip" Corley ***Q3-2017 Letter to Investors*** ***July 10, 2017***

On November 15, 1963, Benjamin Graham, "the father of value investing," delivered a Town Hall address at the St. Francis Hotel in San Francisco titled "*Securities in an Insecure World.*" Mr. Graham cited three possible threats investors should be aware of: 1) atomic war; 2) inflation; and 3) severe market turbulence - especially on the downside! Mr. Graham informed attendees that he did not have the answer for those seeking financial security, or sound portfolio policy, during periods of nuclear war. It is unlikely that any analyst, strategist, or media personality is capable of delivering effective financial advice to residents in countries designated as hot zones engaged in atomic warfare.

How are things shaping up as far as Graham's additional threats: *inflation*, and *severe market volatility?* Not too bad. Neither inflationary pressures, nor unnerving volatility has been a concern thus far in 2017. Inflation as measured by the consumer price index (CPI) is trending at a 1.9% annual rate, which is below the Fed's 2% target. It is surprising that the inflation rate still remains tame at this advanced stage of the economic cycle. Low inflation is seen as a catalyst for higher asset prices. Inflation expectation is a key driver to monetary policy. During periods when the CPI is flat or contracting, the Fed initiates or sustains favorable monetary policy by keeping interest rates low. Lower interest rates and stable consumer prices lead to higher earnings multiples and valuations for stock market indices and real assets. The current stock market and economic expansions are in their eighth year. The duration of this business cycle upswing is the third longest in American history. Stocks have followed suit. The Dow Jones Industrial Average (DJIA) has risen from 6,547 to 21,414 since the bull market began back on March 3, 2009. The Dow is up 227%, ranking it fourth all-time in percentage gains. So far, this bull run has lasted 3,042 days, ranking it second all-time to the secular bull of the 90s. Since World War II, there have been 12 bull markets. The average duration of each bull market has been 57 months. The current bull is in its 99th month. When will it end?



Chief Investment Strategist Sam Stovall says, "Bull markets do not die of old age; they die of fear." What are bulls afraid of? "Recessions!" So, are there any hints that investors can watch out for that may warn them of pending economic halts? That question brings us back to Professor Graham's theory about severe market fluctuations; it appears that Professor Graham is spot on. According to the National Bureau of Economic Research and S&P Dow Jones Indices, extreme market volatility, specifically a stock market downturn greater than 10%, is a leading economic indicator, an unpleasant one at that. Stovall informs investors that since 1948 whenever stocks sold off by 10% or more, the likelihood of a recession following the selloff was 1 out of 3. Investors are wise to take heed if, and when, stocks take a double-digit dive.

No one wants to wait until the market sells off by 10% or more before taking action. There is a better way. Graham suggests that investors with liquid assets maintain a 25% minimum allocation to stocks at all times, and the maximum should be no more than 75%, with the remaining assets invested in bonds, cash, and/or interest bearing instruments. When stock prices sell off sharply and seem undesirable to most folks, a larger stock allocation is warranted by prudent investors. On the flip side, if stocks are expensive by historical measures and investors keep bidding prices higher, a lesser weighting to stocks and a greater weighting to bonds is in order. The seesaw effect is never ending. Taking Graham's allocation suggestion a step further, the rule-of-thumb states, "Invest your age in bonds." In the case of a significant stock market meltdown, similar to the tech bubble of 2000 and financial crisis of '08-'09, older investors are in a better position to stomach the selloff, and younger folks limit their exposure by investing a portion of their assets in safe securities.

Here's the wrap-up; the DJIA has risen 65 days and fallen 56 this year; its average daily volatility was 0.34% on the up days and minus 0.28% on the down days. This compares to a 0.80% average daily price movement over the past decade. Currently, manic stock market volatility is nonexistent, a good sign. Inflation is modest, another good sign. Stock prices are not cheap; be prepared. Interest rates have been rising; do not fight the Fed.

Yours in the spirit of investing,

—William Corley