YOUR FINANCIAL FUTURE

Your Guide to Life Planning

March 2017

Michael Majhanovich & Doran James
Wyoming Wealth Management
2620 Commercial Way Ste 100
Rock Springs, WY 82901
307-382-1177
Fax: 307-382-1133
kathy.hickman@lpl.com
wyomingwealthmanagement.org

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Understanding Value Investing

Buying on the dips is a favorite strategy of committed stock investors. But when looking for investment bargains, it's important to avoid a value trap.

Bond Market Perspectives | Week of March 6, 2017

The bond market is signaling to the Fed that it expects a rate hike in March, earlier than the market was implying in early 2017.

Weekly Market Commentary | Week of March 6, 2017

It should come as little surprise that sentiment among corporate executives improved during the fourth quarter of 2016.

Understanding Value Investing

Investors looking to avoid a value mistake may want to compare a stock's recent trend with a peer group or with a broad market index.

As volatility in the stock market continues, some investors may be tempted to buy on the dips. But this practice raises an important question: Is a low price by itself a true measure of a value stock? If an investor plans to hold a stock for the long term, how can an investor gauge its future potential compared with the broader market?

Value Investing Defined

Value stocks are those that have fallen out of favor in the marketplace and are considered bargain priced compared with book value, replacement value, or liquidation value. Value fund managers typically invest only when they believe the underlying company has good fundamentals. Many value investors think that a majority of value stocks are created because investors overreact to negative events, which can include:

- Disappointing earnings.
- A negative outlook for the industry.
- A regulatory setback.
- Substantive litigation.

The idea behind value investing is that stocks of good companies will bounce back in time when a company overcomes a short-term obstacle and investors ultimately recognize fair value. But this recognition may take time or, in some instances, may never materialize.

Comparative Analysis

Investors looking to avoid a value mistake may want to compare a stock's recent trend with a peer group or with a broad market index. Here are some other suggestions:

- Consider whether a stock has dropped more than the average stock in the S&P 500 during the past three months.
- Examine whether earnings estimates are being revised downward faster when compared with a peer group.
- Compare analyst estimates of future profit margins to historical margins. If expectations for future profits exceed past earnings, the company could end up disappointing investors.

Another technique for potentially avoiding a value mistake is to look for stocks paying dividends. Dividends historically have been seen as a sign of management's confidence in healthy cash flow over the long term, as well as an indicator that management's interests align with shareholders. Even if a stock price languishes for a period of time, a dividend provides an investor with something in the way of a return. Note that dividends are not guaranteed, and a company can reduce or eliminate a dividend at any time.

Perhaps the best strategy for avoiding a value mistake is to combine value stocks with growth stocks, international stocks, and other types of equities to pursue diversification. Although there are no guarantees, owning some of each could help to balance an equity portfolio over the long term.[1]

[1]*Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors. Investing in stocks involves risks, including loss of principal.*

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Bond Market Perspectives | Week of March 6, 2017

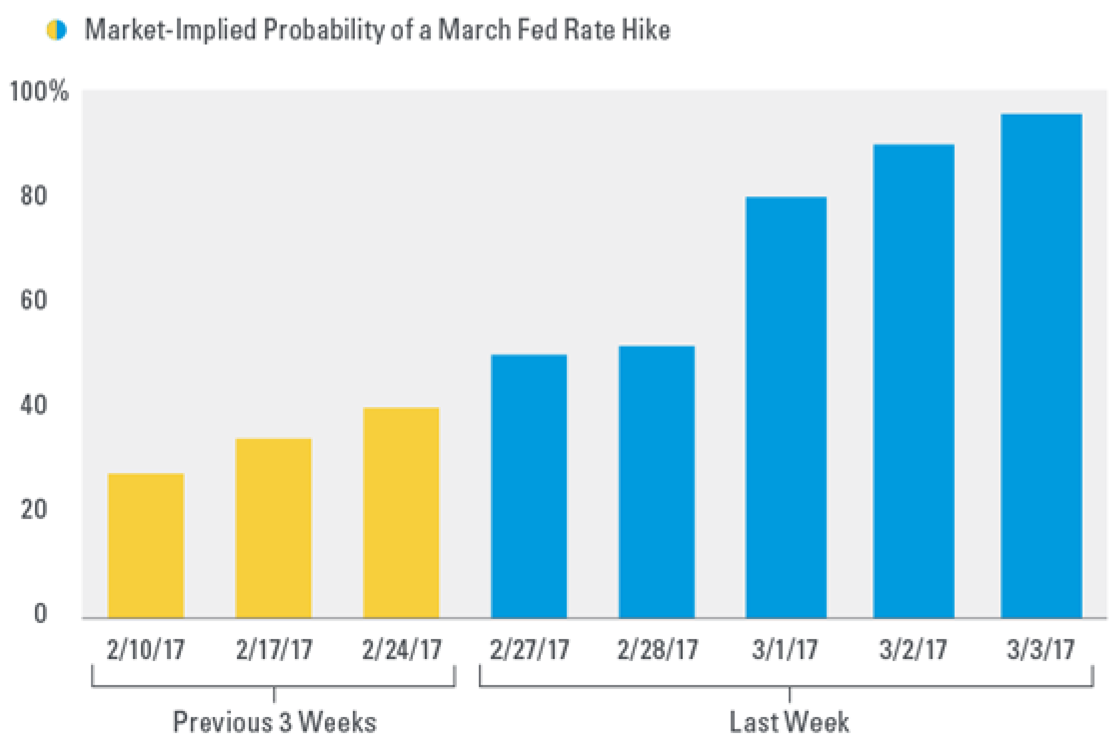
Highlights

- The bond market has almost fully priced in a March 2017 rate hike.
- Hawkish comments from Fed speakers have been a big factor in the bond market's increased conviction in a hike.
- Heightened rate hike expectations have led to a flatter yield curve, which seems to be expressing that the bond market is less optimistic about the economy than the stock market.

Fedspeak Flattener

The bond market is clearly signaling to the Federal Reserve (Fed) that it expects a rate hike in March, earlier than the market was implying in early 2017. A slew of strong economic data was the main culprit, with the push toward growth-focused (and thereby possibly inflationary) policies from the Trump administration still looming in the background. However, the conviction for a March 2017 rate hike was solidified by hawkish, aggressive rhetoric from Fed speakers last week. The fed funds futures market-implied chances of a March 2017 rate hike soared from just 28% on February 10, 2017 to 94% three weeks later on March 3, 2017. The pickup over last week (February 27, 2017 through March 3, 2017) represented the majority of the move [Figure 1].

1 MARCH 2017 RATE HIKE ODDS HAVE NOTCHED UP CONSIDERABLY



Source: LPL Research, Bloomberg 03/03/17

The market-implied chances of a rate hike are calculated based on pricing of various fed funds futures contracts.

THE POWER OF FEDSPEAK

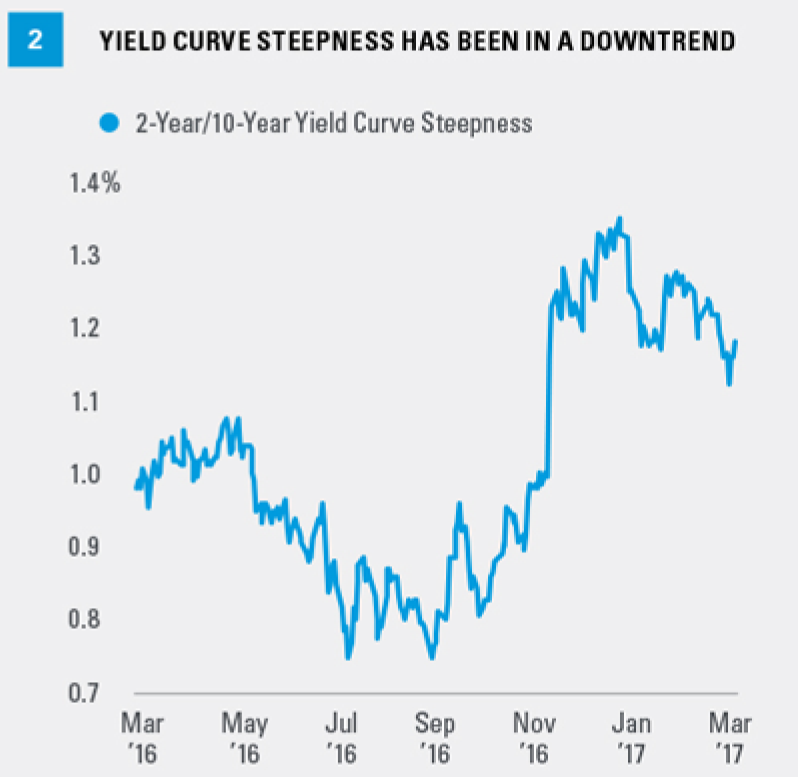
Although the timing was coincidental, we don't believe the move higher in rate hike expectations was a result of President Trump's speech to Congress last Tuesday evening (February 28, 2017). The speech, largely devoid of new information or policy specifics, perhaps soothed markets as it was relatively restrained in delivery, but it is unlikely rate hike expectations would jump so dramatically on that alone.

The main driver of the recent large pickup in rate hike expectations was hawkish Fedspeak from a range of officials, both those considered doves and hawks by the investment community (in chronological order):

- Dudley (dove): New York Fed President Dudley had rather pronounced comments that "the case for monetary policy tightening has become a lot more compelling." He also mentioned that the risks to the economic outlook are "tilting to the upside," as presumed fiscal policy from Washington, D.C. is uncertain but will stimulate the economy to some extent. His comments boil down to the fact that although the Fed wants to hike rates gradually, there is growing concern that not moving soon may result in the Fed getting behind the curve, meaning that inflation will have picked up past a desirable level, necessitating more aggressive tightening, which may be detrimental to the economic recovery.
- Harker (hawk) and Kaplan (moderate hawk): Philadelphia Fed President Harker and Dallas Fed President Kaplan maintained their hawkish tones that three rate hikes were appropriate this year and that a rate hike is possible at the Fed's March meeting.
- Williams (dove): San Francisco Fed President Williams noted that the economy was at full employment nationwide and that a rate hike in March was a "serious consideration."
- Brainard (dove): Fed Governor Brainard mentioned her willingness to raise rates "soon."
- Powell (centrist): Fed Governor Powell reiterated the comments of Harker and Kaplan; three rate hikes seem appropriate in 2017, and March is on the table.
- Yellen (dove): Fed Chair Janet Yellen provided markets the most pointed and ultimately important Fedspeak of the week. She said on Friday (March 3, 2017) that a March rate hike "would likely be appropriate" if "employment and inflation [continue] to evolve in line with our expectations." Shorter-maturity rates popped higher on the comments, and March rate hike expectations moved from 92% before her speech was released to 96% immediately after.
- Fischer (centrist): Fed Vice Chair Fischer, when asked whether the Fed speakers this week were part of a "conscious effort" to increase rate hike expectations, answered that if so, he was "about to join in," saying he strongly supports the views of the other Fed speakers' hawkish tilts.

YIELD CURVE FLATTENING

The consistency in hawkish Fedspeak pressured shorter-term Treasury yields higher throughout the week. Longer-term yields rose, but not as much, leading to a flattening of the yield curve. A flatter yield curve can usually be interpreted as a sign of lower growth and inflation expectations: investors are at least temporarily willing to buy longer-maturity bonds for the additional yield because they don't think that inflation is an immediate risk. Yield curve steepness has gradually declined since mid-February, and events last week (February 27, 2017 through March 3, 2017) have moved the yield curve to its flattest point year to date. Though it has recovered somewhat since, the spread between 2-year and 10-year Treasuries on February 28, 2017 was at its flattest level since November 9, 2016, the day after the election [Figure 2].



Source: LPL Research, Bloomberg 03/03/17

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

Past performance is no guarantee of future results.

Another oft-cited measure of yield curve steepness is the 5-year/30-year. This metric looks at the steepness with less influence of the Fed, which has more of an impact on the 2-year Treasury and shorter-maturity bonds. This metric is approaching the 1% level reached mid-2016, early 2015, and during the recovery from the financial crisis [Figure 3].

These measures of yield curve flattening seem to be indicating that fixed income markets are sending messages that differ from those of equity markets. As equity markets press to successive record highs, fixed income markets are expressing some pessimism that Trump's agenda will be very stimulatory, or perhaps that the agenda itself is at risk of coming to fruition. With fixed income markets more subdued immediately ahead of the Fed's decision, time will tell whether fixed income markets catch up with equity markets on growth expectations, or vice versa. There are other forces at play as well. Due to low global developed market sovereign yields, foreign buyers continue to enter the Treasury market opportunistically when rates move higher. This may also be contributing to the flattening of the yield curve.

WHAT HAPPENS IF THE FED HIKES?

The presumed March rate hike would be the first non-December hike of this tightening cycle. After hiking in December 2015 and 2016, the Fed and the market agree that Fed rate hikes will be coming at a faster pace in 2017. So how will markets react? The two most recent hikes provided disparate examples. In December 2015, a rate hike contributed to equity market weakness that lasted through January 2016. Importantly, other serious issues were also occurring at that time: economic concerns around China and oil price weakness, which stoked default fears in energy companies and general equity market unease. In December 2016, equity markets shrugged off a Fed rate hike and continued their post-election advances.

CONCLUSION

So which way will markets go this time? Absent any dropoff in economic data, the economy appears to be on solid footing, with no real "problem children" as with the energy sector in 2014-2016. With the fed funds futures market almost fully pricing in the March rate hike already, we don't expect a large-scale move in fixed income markets as a result of a hike. Entering the week prior to the Fed meeting, market-implied chances of a rate hike in December 2015 were just 78%, while entering the week prior to the December 2016 hike they were 100%. A market expecting a hike is less likely to be jarred by one. With roughly one week until the potential March 2017 rate hike, odds at 98% (as of March 7, 2017) are a comforting sign that the bond market may be ready for another rate hike.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

International debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

DEFINITIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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Weekly Market Commentary | Week of March 6, 2017

HIGHLIGHTS

- Our analysis of fourth quarter 2016 earnings conference call transcripts indicates sentiment among corporate executives continued to improve as 2016 ended and 2017 began.
- Policy was a popular topic, as taxes, infrastructure, and regulation saw big jumps in the number of mentions. Currency and China also continued to garner a lot of attention.
- Solid fourth quarter 2016 results and improved sentiment from corporate executives support our expectation for mid-to-high single digit earnings growth for the S&P 500* in 2017.

FOURTH QUARTER 2016 EARNINGS SEASON

Fourth quarter earnings season has not been a blowout by any stretch, but growth has been solid at near 8%, putting the earnings recession further in the rear view mirror. Potential policies out of Washington, D.C. have dominated discussions, but there have been many other items of note, including resilient guidance, strong profit margins, and particularly strong results relative to expectations for the financials, industrials and technology sectors. Please see our February 21, 2017 Weekly Market Commentary for some of our key earnings season observations.

**We expect mid-single-digit returns for the S&P 500 in 2017 consistent with historical mid-to-late economic cycle performance. We expect S&P500 gains to be driven by: 1) a pickup in U.S. economic growth partially due to fiscal stimulus; 2) mid- to high-single-digit earnings gains as corporate America emerges from its year-long earnings recession; and 3) an expansion in bank lending; and 4) a stable price-to-earnings ratio of 18-19.*

CORPORATE BEIGE BOOK: BETTER SENTIMENT AND LOTS OF TAX TALK

It should come as little surprise that sentiment among corporate executives improved during the fourth quarter of 2016. We saw relatively more use of strong and positive words compared with weak and negative words in our analysis of earnings conference call transcripts. Talk of recession remains virtually non-existent, supported by solid economic data of late. Significant discussions of taxes also came as no surprise given market participants' focus on corporate tax reform and the possible border adjustment tax. Finally, currency and China continued to garner a lot of attention, while energy and Brexit faded. Note that our analysis covers fourth quarter 2016 earnings calls that took place from mid-January through the first three weeks of February.

WHAT IS THE CORPORATE BEIGE BOOK?

We use earnings conference call transcripts to gauge overall sentiment of corporate management teams, much like we have done with the Federal Reserve's (Fed) Beige Book to create our Beige Book Barometer (the Fed's Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Fed districts). To create our Corporate Beige Book, we count the number of strong words (or variations of "strong") and the number of weak words (or variations of "weak") and calculate the difference between the two. (Examples of strong words include "robust," "solid," and "optimistic;" examples of weak words include "soft," "fragile," and "pessimistic.") We can then compare that differential to prior quarters to make comparisons over time. Although not every single call transcript is analyzed, we believe the trends observed provide valuable insights.

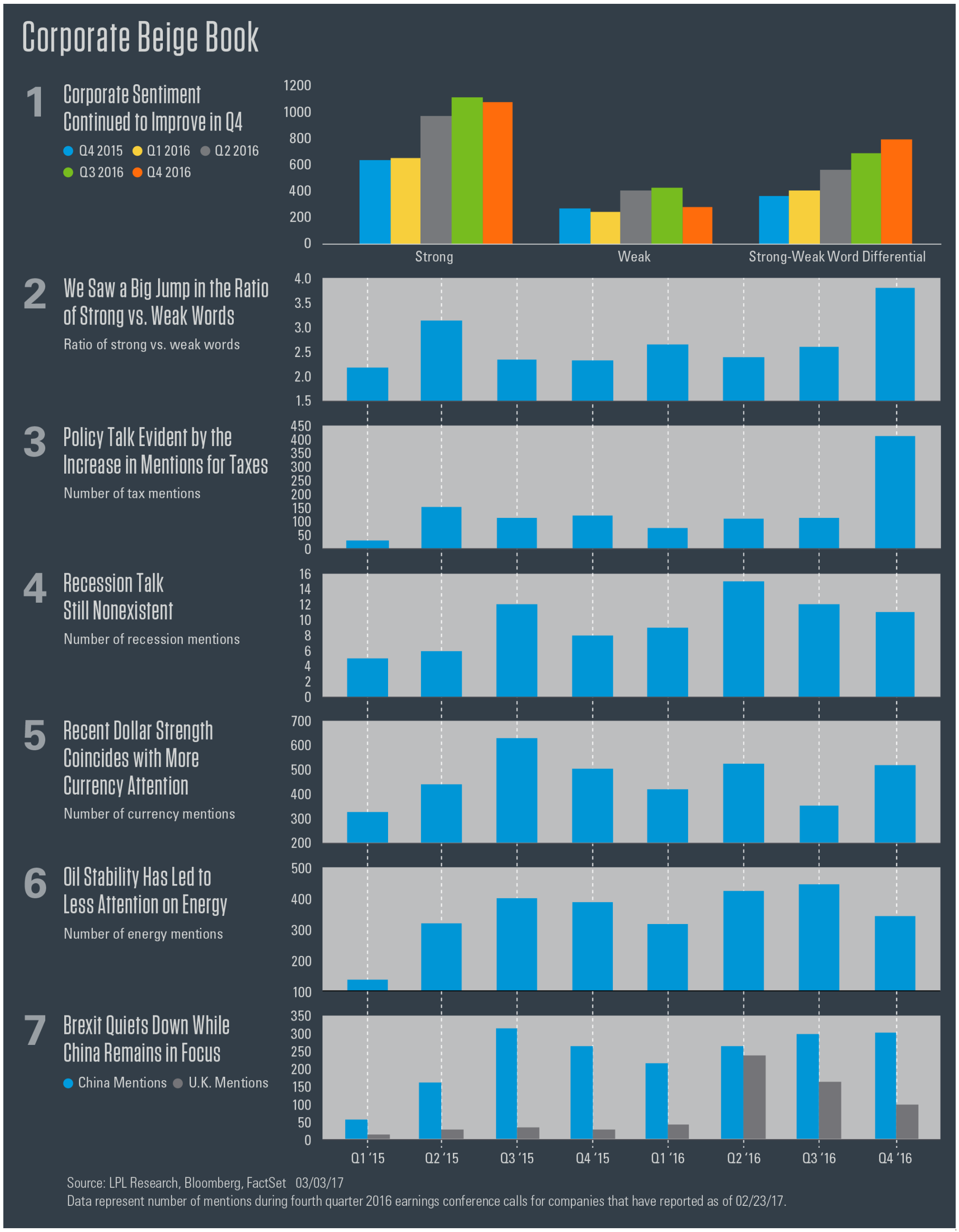
ANOTHER IMPROVEMENT IN MANAGEMENT TONE

When we count positive and negative words from earnings call transcripts, we see that sentiment among corporate executives continued its impressive streak of improvement in the fourth quarter of 2016. The total overall use of strong and weak words declined quarter over quarter, but the use of strong and positive words (e.g., "strong," "robust," "solid," "improving," "good") fell much less than the use of weak words (e.g., "weak," "soft," "difficult," "challenging"), pushing the differential between strong and weak words higher, which we refer to as our Corporate Beige Book Barometer **[Figure 1].**

The differential between strong and weak words in our analysis rose 15% to 789 in the fourth quarter of 2016, after a more than 20% increase in the third quarter of 2016. The improved sentiment is even more apparent when looking at the ratio of strong to weak words, which jumped from 2.6 in the third quarter to 3.8 in the fourth quarter **[Figure 2]**.

We are encouraged that this analysis generally reflects the improved conditions in corporate America that we have observed in the economic data, in the reported earnings and revenue numbers, and anecdotally in the enthusiasm around pro-growth policies from Washington, D.C.

Click here for the figures referenced in this week's *Weekly Market Commentary*.



POLICY TALK DOMINATES

After little policy talk from corporate executives during 2016's third quarter earnings reporting season (roughly mid-October 2016 through mid-to-late November 2016), much of which occurred before Election Day, we saw a huge spike in policy discussions in fourth quarter conference calls. The policy focus for executives, analysts, and investors is evident in the sharp increase in the use of the word "tax" (or "taxes") as shown in **Figure 3**. We highlighted the increased attention on tax reform in our *Weekly Market Commentary* two weeks ago that revealed tax policy getting more mentions than any other policy topic (source: FactSet).

On a related note, we were surprised that the controversial border adjustment tax did not get more attention, although it did go from receiving no mentions in our sampled transcripts in the third quarter to a few dozen in the fourth quarter. Other key policy topics included trade, which saw a big jump in mentions in the quarter (32 to 91), regulation (7 to 36), and infrastructure (20 to 34).

Here are some executives' comments on tax reform, including a mention of the border adjustment tax:

- *"From our perspective, we believe that any type of corporate tax reform would be positive for us, because as you know, in the agricultural sector, being a U.S. domiciled company, we pay the highest tax rates in the industry." (Agriculture)*
- *"We strongly support comprehensive corporate tax reform. Lower corporate tax rates will encourage investment, create jobs, and make the U.S. a more competitive country." (Transportation logistics)*
- *"Any relief on corporate taxes would be a benefit, subject to any of the other provisions that may get put out*

there such as the border adjustment tax that you alluded to. So, a lot of kind of ambiguity out there, and we really won't know more until later in the year when some of this comes into clear focus." (Building materials)
- *"As you know, approximately 65% of our revenues are derived from the U.S. and therefore, we pay a significant amount of U.S. corporate taxes. If there is a reduction in the corporate tax rate, we would expect to benefit from it." (Industrial equipment)*

Here are some executives' comments on trade:

- *"Obviously, there are still many questions about the future of NAFTA and the trade relationship between the U.S. and Mexico. While we've gotten some indication of the direction of the new administration through the nomination of most of the key trade policymakers, we still don't have definitive answers to several of those questions. What we do know is that the President's team has indicated that there will be a process for reshaping of America's trade policies which could include updating NAFTA." (Railroad)*
- *"I think clarity sooner rather than later would be particularly helpful and would be on a lot of discussions. That's really what they are at the moment, discussions around trade policies as they relate to both Mexico and China, and some of the other trade partners that we have. So in our view the sooner that gets cleared up and resolved, I actually think there could be a further uptick." (Industrial equipment)*

Comments on infrastructure:

- *"[With regard to infrastructure] …whether it be some kind of infrastructure private-public partnership credit program, whether it's some kind of a grant program, there is a whole bunch of different permutations then to what could unfold. But I'd say step one corporate tax reform, this is just my opinion. Step two, infrastructure, and you'll see it coming out of the administration what they choose to prioritize and then our focus will follow suit." (Railroad)*
- *"We believe the case for infrastructure development is clear. A world-class infrastructure is the backbone of a modern healthy U.S. economy. In addition, reduction of Federal regulations will also make the U.S. economy more vibrant." (Transportation logistics provider)*

And comments on deregulation:

- *"There is this broad desire to roll back regulations, but I don't know that we know of anything that is specific. We plan to spend time in Washington here in the first quarter and hopefully by April, may have a bit better read on that, but we've looked at, which is a broader corporate issue, we've looked at the tax reform proposals and we're quite excited about that on the corporate front, but that's just about income tax." (Airline)*
- *"First, in an overall sense, I've been very pleased with the agenda that the Trump administration has. We have seen an avalanche of regulation over the last decade, and putting a much more balanced cost/benefit framework of that is quite positive for our business, for the country, job creation, and a lot of things." (Oil and gas)*
- *"In addition, reduction of Federal regulations will also make the U.S. economy more vibrant." (Transportation logistics)*

TALK OF U.S. RECESSION NONEXISTENT

Corporate executives generally try to stay away from the "R" word (recession) when talking with investors, confirmed by the small number of mentions of the word in the fourth quarter of 2016 (11) **[Figure 4]**. The average number of times the word recession was mentioned during earnings calls over the past eight quarters at less than 10 has been surprisingly low, and several of those were related to overseas economies. We think these data points, along with our assessment of leading economic indicators, continue to point to low recession odds in 2017.

DOLLAR BUMP PUTS IT BACK IN THE SPOTLIGHT

The number of mentions currency received during fourth quarter 2016 earnings calls jumped 47% from the third quarter of 2016, **[Figure 5]**, though the number of mentions still trailed the peak during the U.S. dollar surge of 2015. Several factors have contributed to the increasing attention. First, the dollar was very strong in the fourth quarter of 2016 with a 7% rise based on the DXY U.S. Dollar Index. After a dip in January 2017, the dollar regained strength in February as Fed rate hike expectations accelerated, rekindling fears of currency-driven earnings weakness and commodity price declines (historically, commodity prices and the U.S. dollar tend to move in opposite directions). In addition, the possibility of a border adjustment tax, which could be very bullish for the dollar if enacted (we remain skeptical) likely put some upward pressure on the dollar.

As we noted in our *Outlook 2017: Gauging Market Milestones* publication, we expect U.S. dollar gains to be relatively modest this year.

HIGHER PRICES PUT OIL ON THE BACK BURNER

Oil's rise from the February 2016 lows in the mid-$20s to its current price in the mid-$50s has eased concerns about the negative impact of low prices on energy and energy-sensitive companies, reflected in the drop in the number of mentions the topic received on fourth quarter 2016 earnings conference calls **[Figure 6]**. Energy notably produced a year-over-year increase in earnings in the fourth quarter of 2016 for the first time in two years.

CHINA STILL A FOCUS; BREXIT, NOT SO MUCH

In June and July of 2016, the U.K. was the primary geographic focus for corporate executives following the unexpected vote in favor of Brexit (i.e., the vote for the U.K. to leave the European Union). Since then, the U.K. economy's resilience and strength in global equity markets (and certainty the shift in attention toward U.S. elections and Trump's policies) have seemingly left executives comfortable with the risks and investors and analysts less interested in the topic. Accordingly, as shown in **Figure 7**, U.K. mentions collapsed in the fourth quarter, falling 40%. Among those that did mention Brexit, few cited it as a near-term risk and even fewer cited it as a reason for fourth quarter weakness.

Meanwhile, despite relative stability in the data and markets during the fourth quarter of 2016, China continues to get a lot of attention because of the potential for more protectionist trade policy. China will likely continue to garner significant attention in the months ahead as Trump's trade policies take shape, while China's economic stability, at least for now, is encouraging. A significant majority of the executives' comments about China cited favorable business conditions.

CONCLUSION

Our Corporate Beige Book suggests that corporate executives have become more and more confident in the macroeconomic outlook in recent months, due in part to prospects for pro-growth policy including tax reform from the Trump administration. Solid fourth quarter results and the improved sentiment from corporate executives support our expectation for mid-to-high single digit earnings growth in 2017. For more of our thoughts on fourth quarter earnings season, please see our February 21, 2017 *Weekly Market Commentary*.

INDEX DESCRIPTIONS

The Standard & Poor’s 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains “strength” compared to other currencies.