It’s been a while. Those of you who are consistent consumers of *CAPSTONE Comments* will note that this publication has been out of print, as it were, for some months now. We are excited to get back in the rhythm of providing our comments to you on a monthly basis and will do so going forward with a slightly different lens and structure.

In the past, our written thoughts have focused mostly on items within the capital markets and economy which we felt most relevant for further examination and discussion. While economic and market commentary will remain a cornerstone of our conversation going forward, we feel it necessary to broaden our scope and examine other topics of equal importance and curiosity as well. As always, *CAPSTONE Comments* has not and will never be a replacement for the personal communication between you and us, our client, and as such is not designed to address every possible inquiry or concern. Our objective is to provide timely and relevant commentary that makes us better for having wrestled with it in the writing and makes you better for having taken valuable time to read it.

Towards that end, we’ll focus each month on one of the following topics and rotate through them throughout the year:

- Markets and Economy
- Financial Planning Considerations
- Estate & Legacy Planning Considerations
- Capstone Family News and Events

Having said all that, let’s jump back into things this month with a look at the **Capital Markets and Economy:**

One should not quote Charles Dickens flippantly but his famous words written to begin his timeless work, “A Tale of Two Cities” seems more appropriate now than ever as it relates to both the fear and relative calm we have experienced in the markets to date in 2017. It feels as though it is indeed “the best of times and the worst of times” depending on the topic and the person you’re asking. From a thirty-thousand-foot view of the markets, one can simultaneously exult in the new highs we have reached in US stocks and fret about being one-day closer to the next bear market which will inevitably come. Each tick upwards seems to not only increase the market’s value but its anxiety as well. The fact that such anxiety is not measurable to any degree in the form of market volatility only serves to heighten the anxiety even further. Is it the best of times, and we’re simply not seeing it, or are we witnessing the beginning of the end for one of the longest bull markets in history? Let’s look at the broader economy, the Fed and the stock and bond markets to see what we can learn.

US Economy

With respect to the US economy, it is estimated that US GDP growth will barely come in at 2% for 2017. This is the third straight year of declining GDP in the US and the lowest since the end of the Great Recession. When we look broadly at the underpinnings for this data, we constantly find ourselves coming back to the issue of demographics. Simply put, with the exception of medical care, one’s consumption generally peaks in the late 40’s and declines from there. We are witnessing the largest generation in our history (the Baby Boomers numbering some 76 million) retire at a rate of

roughly 10,000 per day and their rate of consumption that previously helped fuel a massive expansion in the US economy, is declining.

Birthrates in the United States are presently not keeping pace with that trend and, if it were not for immigration, both legal and illegal, we would likely have already been in a recession. That is not a veiled attempt by the author to poke at what is a politically sensitive issue, it is simply stating the facts of our present demographics and the economic consequences. To summarize, the US economy is arguably approaching stall speed and has been for some time. This does not mean that a recession is inevitable or a stock market correction is necessarily around the corner. It simply means that one should not be blind to the underlying realities that can easily be dismissed when looking at the unemployment rate (4.3%) or the stock market (Dow at 22,000). The raw data matters but the quality of the data is far more important.

Interest Rates and the Federal Reserve

This leads us to the Federal Reserve and their "management" of the recovery since the Great Recession and what that means for interest rates and business conditions. Currently, the Fed Funds Rate stands at 1.25%. A year ago, it was .5% and by the end of this year it is expected to be 1.75%. The Fed is raising rates as it seeks to "normalize" the interest rate environment. The Fed Funds rate is the rate at which banks can borrow from the Fed and is a foundational rate that effects everything from home mortgages to car loans.

Interest rates generally move higher as business conditions improve and the economy needs to be kept from "overheating." Returning the 2% GDP growth figure we referenced previously it seems odd that the Fed would see any need to raise rates. There is no sign of inflation as the Fed measures it, grocery bills, tuition and medical costs notwithstanding. So why is the Fed raising rates when the economy is not showing signs of robust growth that is distributed beyond the ultra-wealthy? A couple reasons:

First, it is our belief that the Fed is engaged in seeking to not only respond to the economy as it is but to help shape the economy they want to exist. They're seeking to create a sense that economic growth is robust as evidenced by their rising rates and as such that will hopefully spur more business loans, more hiring, etc. The Fed is seeking to instill confidence with the belief that confidence will breed more confidence and that their guidance will become a self-fulfilling prophecy of broadly shared prosperity.

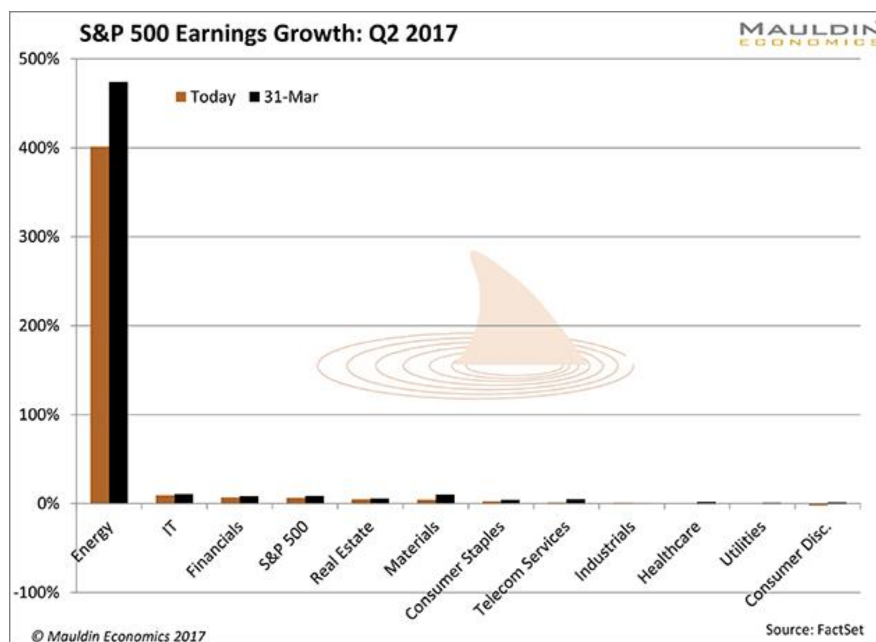
Second, they are seeking room to maneuver if/when the next recession comes. With rates hovering near zero, there is very little they can do to respond to a financial contraction. As odd as it may seem, they need to raise rates in part so they have the flexibility to lower them if need be. We anticipate rates to continue to climb throughout the remainder of 2017, consistent with Federal Reserve guidance, and do not believe rising rates will be a meaningful impediment to economic growth. We believe it more useful to view interest rates in this environment as a critical indicator that is responding to economic conditions and not as a driver of economic conditions. What does this mean for stocks?

US Equity Market

The rally in US stocks since the election has been tremendous with little volatility to accompany the move higher. This move is largely due to expectations of sweeping tax reform, not to improving corporate fundamentals. A quick look at the numbers:

Presently, the S&P 500 is trading at a P/E (Price to Earnings multiple) of 24. This means that for each $1 of earnings you pay $24 when you buy the S&P today. The P/E multiple is one of many valuable metrics for value investors to determine how "cheap" or "expensive" stocks may be at any given time. An average price for the S&P is to buy it at a P/E of 16. Based on this average figure, the market is overvalued by roughly 50%. If the market and its earnings grows at a pace greater than average, then buying the market when it's more expensive may be warranted. The point of this brief analysis is simply to say that, by historical standards, the market is expensive. It is not as expensive as it has been at previous market peaks but it's not cheap. One must at least be prepared for a pullback of some magnitude or believe that corporate earnings will continue to grow at a pace to justify the valuation.

Second quarter earnings for 2017 are in and they were great in terms of year over year top-line earnings growth. The total earnings growth for the S&P for the Second Quarter of 2017 was a solid 9.1%. Like any data point, it's critical to understand what underlying data created that aggregate statistic. Below is a breakdown of earnings growth for each of the 10 sectors that comprise the S&P 500:



The careful observer will note that the Energy sector stands as a notable outlier to the rest of the S&P sectors. It's not that other sectors didn't have earnings growth, it's just that the Energy Sector carried the day by a factor of roughly 400 times. If we remove the Energy Sector from the calculation by assuming an earnings growth rate of 0.0% for those companies, the S&P earnings growth goes from 9.1% to 3.6%. Still growth, but hardly the robust figure that Wall Street would champion. Why did Energy do so well? It's not that it did well it's that it's finally doing less bad. The sector's earnings are finally beginning a modest rebound from multi-year lows and this figure captures some of that normalization but is not a picture of vibrancy for the sector.

What's the takeaway for US stocks? They're expensive by historical standards and could move even higher but a pullback is inevitable as it always is. If you own them, know why you own them and have a strategy for how you'll respond to market turbulence both emotionally and within your portfolio when the rough patch ultimately comes.

The Financial Crisis, in many respects represented a break in paradigm from what we could previously model and expect. The comments below capture the essence of this environment that we are seeking to understand and respond to:

"The financial crisis turned what outwardly seemed a stable political and financial environment into what mathematicians and physicists would call a "dynamical" system. The main characteristic of such systems is radical uncertainty. Such systems are not necessarily chaotic — though some may be — but they are certainly unpredictable. You cannot model them with a few equations... Radical uncertainty is a massive challenge, because you can never be sure of much. In particular, you can no longer be certain that you can extrapolate the trends of the past into the future. Opinion polls are becoming less relevant (even if they were able to produce a correct snapshot of opinion at any one time). Even ultra-modern tools like social network analysis cannot break through into an unknown future. The usefulness of these tools is confined to explaining what went wrong in the past." – Wolfgang Munchau, Financial Times

Expect the unexpected and control what you can control. That is our objective as it relates to asset management and financial planning and we seek to grow and learn as students of those disciplines each and every day.

Capstone Family News and Updates

Client Appreciation Event: September 19th

Many of you may have already received your "Save the Date" for our annual, Client Appreciation Event which will again be held at Indian Summer Country Club. We hope to see you there for a fun and festive event celebrating you. For more information, give us a call or check your inbox.

A New Addition!!

Perhaps the most fun and important piece of news is that our Office Manager, Janine, and her husband Dan are expecting an addition to their family this January. As they prepare to welcome a new life into the world, we are excited to do likewise and support them on that journey as new parents.

Medical Leave

Founding Partner, Pat McClelland, will be out on medical leave for the next several weeks with the hopes to return the second week of September. Just to calm any concerns, Pat underwent a surgical procedure on his foot which will require a great deal of rest and recuperation. We wish him the best during his recovery time. Please know, your CAPSTONE team is here to assist with client meetings and servicing requests. Partner, Sandi Drennon and Jeff Wachtman, Portfolio Manager/Financial Advisor, will be covering any needs and requests in Pat's absence. For more information, give us a call or email janine@capstoneig.net

We thank you again for the privilege of serving you and we look forward to seeing you soon!

Kindly,

The CAPSTONE Team

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