MARCH 2017

Summary

Both stocks and interest rates have risen since the election last November. We delve into the reasons why.

Many of the positive expectations built into stock prices are probably over-optimistic; but the economy is on solid footing nonetheless.

Our basic expectations about economic growth and inflation are unchanged – both will increase at approximate a 2% annual rate.

Earning are growing again, but valuations have gotten ahead of them.

For the short term, our allocation is cautious but positive over the inter-mediate term.

Barbara gives an overview of retirement planning, and Jordan introduces SRI/ESG.

Rick describes some changes coming to our financial planning group.

Economic & Market Review

by Brad Bickham, CFA, CFP®
Chief Investment Officer

As of 2/28/17	YTD 2017	Last 12 Months	Last 5 Yrs. Annualized
60/40 Balanced World Index	3.7%	14.2%	6.1%
World Equity Index (ACWI)	5.5%	22.7%	8.4%
U.S. Equities (Wilshire 5000)	5.6%	26.7%	13.9%
Foreign Equities (ACWI-ex U.S.)	5.2%	19.3%	3.6%
U.S. Bonds	0.9%	1.4%	2.2%
HFRI Fund of Funds Composite	0.7%	5.3%	2.9%

Dear Clients and Friends,

What a difference a year can make. It is instructive to look back to where we were a year ago. In our newsletter last spring, we noted the subdued returns we had experienced the year before along with recent volatility. You may remember 2016 began with a correction of 10% or more in stock markets around the world, before staging a strong rally from mid-February through March. Most strategists had predicted a mild year for investments, but instead stocks provided double digit returns in the U.S. with somewhat lower but still positive results overseas. Interest rates fell to 1.3% on the U.S. 10 year Treasury bond in the summer, before doubling to 2.6% by year end. Similarly, oil prices fell to $26 before doubling to over $50 by year end. And the coup de grace to forecasters was of course the U.S. presidential election. Everyone missed that one. So I will try and refrain from too many predictions. Rather, I will attempt to explain why the markets have performed the way they have the last few months, and to explore some longer term trends and issues.

While I usually argue that politics has a lot less to do with market moves than most people think, it is undeniable that there was an inflection point coinciding with the U.S. presidential election as shown on the two charts on the next page.

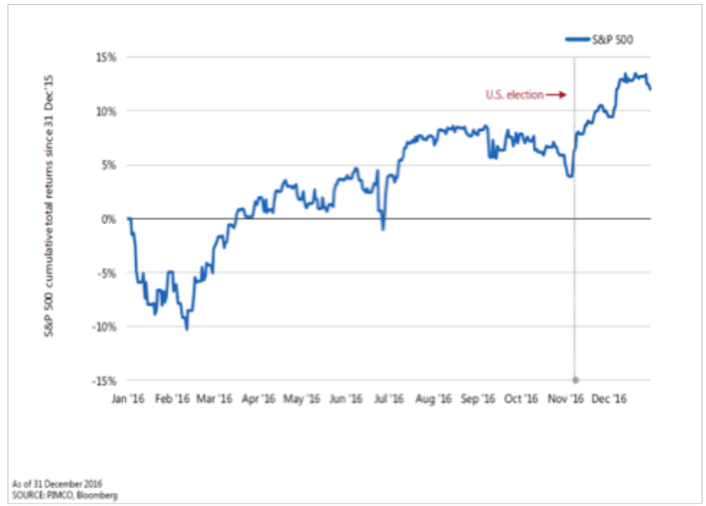
Immediately following the election we saw stocks and interest rates rise. Why?

One commentator recently called it a "Sweep rally" rather than a "Trump rally". His point was that nobody expected the Republicans to sweep the House, Senate, and Presidency. Rightly or wrongly, a preponderance of investors believe that a Republican Congress and White House will be more business friendly; and their platform is for lower taxes, less regulation, and even a big stimulus plan. It is easy to see the logic of the stock market's move in that context. Less regulation and lower corporate taxes lead to rising profits. Lower taxes on individuals lead to stronger economic growth, so the thinking goes.

How about the rise in interest rates? Why such a sharp increase? Remember that the U.S. is already close to or at full employment. Any pick up in the current level of economic growth should lead to rising wages and inflation. Add to that the idea of a stimulus plan and lower taxes and you get rising deficits. The combination of a rising deficit and expected increase in economic growth leads to rising inflation expectations, and subsequently rising interest rates.

Let's examine each of these assumptions. First, the new government is expected to reduce regulations. This seems pretty straightforward and difficult to argue with. Some will rightfully point out that too little regulatory oversight leads to excesses and bubbles such as the financial crisis of 2008; and there is not a direct a line between regulations and economic growth. But, we can safely assume that regulatory burdens slow productivity (increase costs), so chalk this one up as a positive for economic stimulus.

How about corporate taxes? Lower taxes mean higher profits – right? It is possible that it will be, but it is not clear what will happen with corporate taxes. There are many corporate tax deductions in the U.S. that other countries do not have. There is talk of changing some of these, so the net effect of a lower rate may be smaller than expected. Further, it is not empirically obvious that tax rate changes have changed profitability in the past.



As of 31 December 2016
SOURCE: PIMCO, Bloomberg

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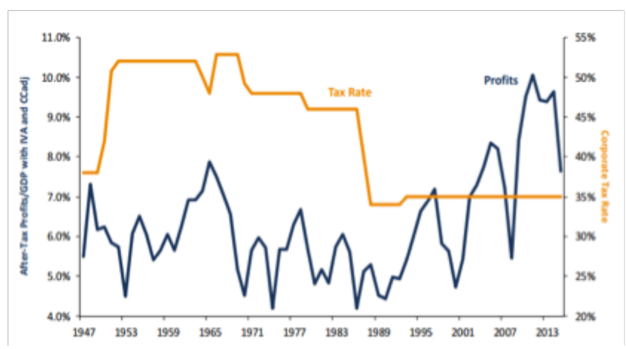
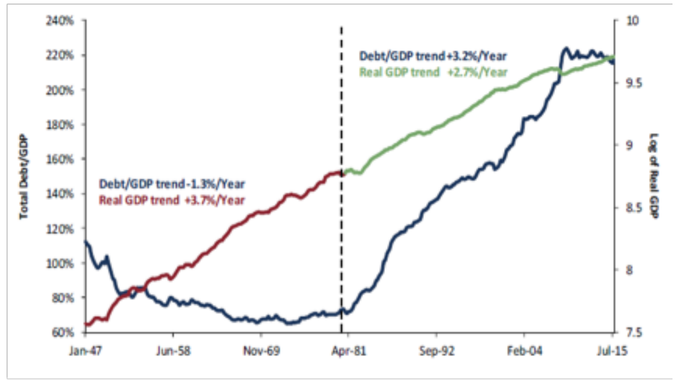
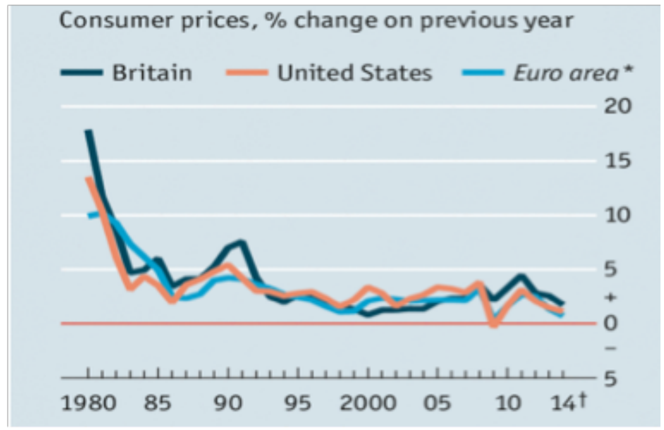


You can see from the previous chart that tax rates were lowered in the 1980s and the profit spike did not happen until 20 years later. The same is true for taxes on individuals. According to a 2012 report from the nonpartisan Congressional Research Service, top marginal tax rates and economic growth have not appeared to be correlated over the past 60 years.

The next assumption is that a large fiscal stimulus plan (think re-building roads and bridges, and increased defense spending) will stimulate the economy, especially if we do it with borrowing rather than taxing. Once again, the empirical evidence does not bear this out.

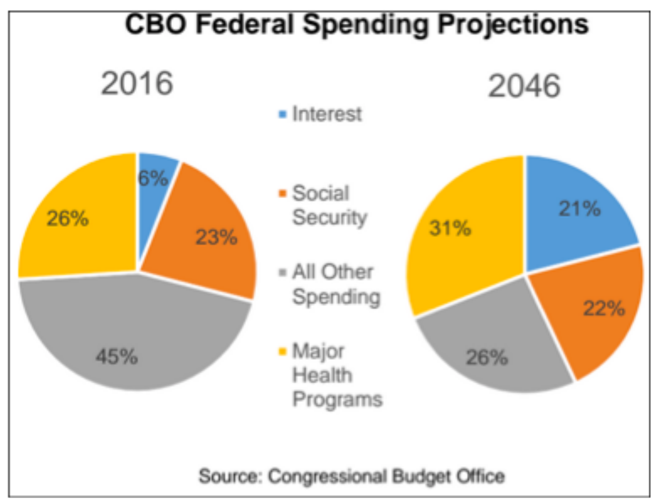


As shown in the chart on the top right, increasing debt has had no impact on growing GDP; and in fact, many economists argue that the level of debt to GDP has gotten so large that it has and will cause a slowdown in growth.



From a long-term point of view, investing in infrastructure is a necessary and beneficial thing. If the government can borrow money at 3% such as they can now, and make wise investments the return on that investment should be far greater than 3%. However, it is unlikely something we will see a payback on in the next 12 – 24 months as is being argued.

How about the question of rising inflation and interest rates? As someone born in the early 1960s, my formative years were the '70s when inflation was out of control and short term rates reached 20%, and mortgages were over 10%. But that was really a historical aberration. As shown, inflation has been subdued for the last 20 years.



More recently, while inflation has picked up some, it is still hovering around 2% and we believe it is unlikely to rise above 3%.

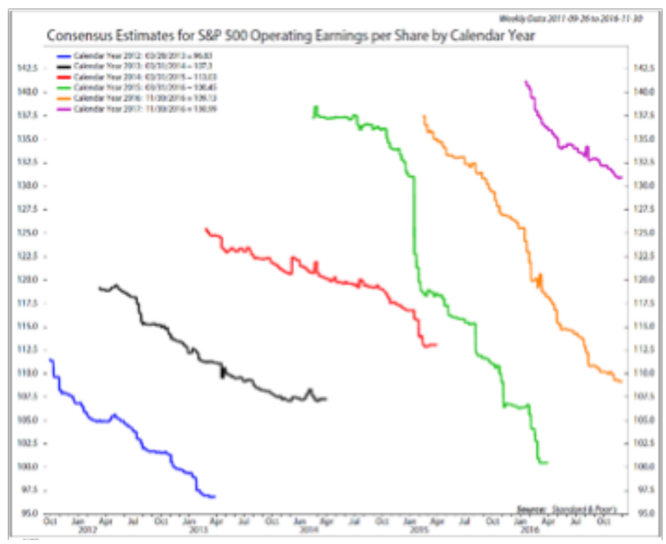
Ultimately, interest rates are tied to inflation, so if inflation doesn't rise, then interest rates won't rise either; and that is critically important because if interest rates rise they will crowd out other government programs. The pie chart shows the breakdown of federal expenditures – now and 30 years in the future. If rates rise, then there will be a huge increase in interest expense and a lot less for defense, education, infrastructure spending, or anything else.

If many of the assumptions baked into the current sentiment are untrue, does that mean the economy is doomed to slow growth? Not necessarily. Sentiment is an important driver of economic activity and this factor has improved markedly as shown in charts on sentiment and confidence.

And, remember that unemployment is below 5%. We are continuing to see job growth and modestly rising wages. <u>Therefore, our conclusion remains that economic growth, interest rates, and inflation will not change materially from the last few years… ~2% GDP growth, ~2% inflation, and interest rates rising modestly.</u>

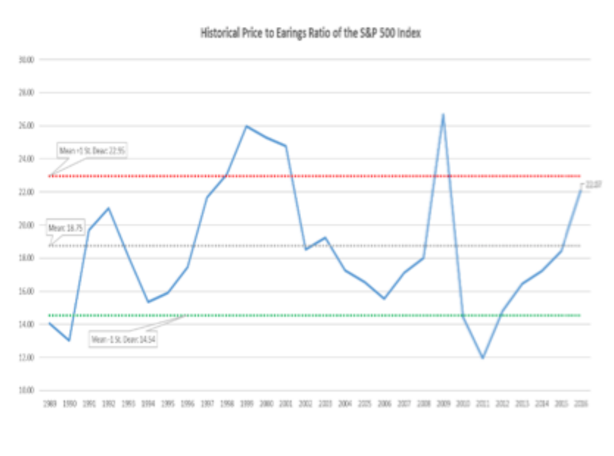
Earnings and valuation

Earnings grew last year but have yet to surpass the 2014 level. This year is expected to show a recovery, but analysts are consistently over-optimistic, as shown in the third chart. You can see from this chart that over the last two years the drop in actual earnings from what was estimated at the beginning of the year was particularly large.



Will 2017 be the year when earnings come closer to the original estimates? If not, then the market is vulnerable to disappointment because valuations are stretched. Current prices can only be justified based on aggressive assumptions as contrasted in the two charts on the right.

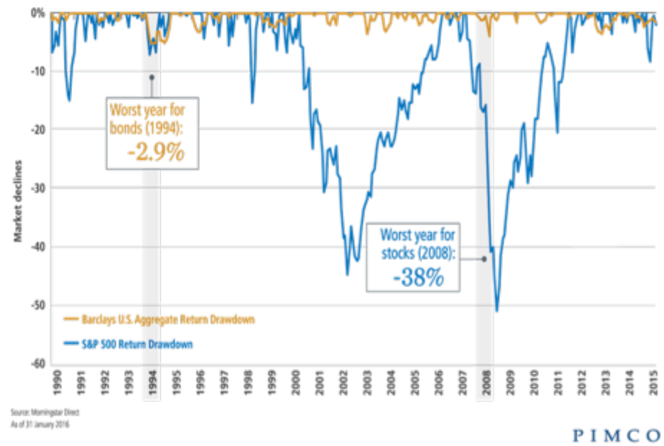
The PE ratio based on forward estimated earnings is only slightly above its 25 year average, as shown by the chart on the bottom right. But the market is overvalued based on trailing earnings, as shown in the chart below.



Asset Class Comments and Asset Allocation Strategy

Why bonds?

We are often asked this question since our expectation is for low returns from this asset class, and this chart explains it best. A bad year in bonds is not very bad. They provide income and safety in your portfolio when the stock market has negative returns.



Our strategies to improve performance versus traditional investment grade bonds include diversifying into higher yielding and foreign bond funds, keeping an overall duration shorter than the bond index, and holding primarily dollar denominated funds. We have some tactical hedge positions in TIPS and non-dollar foreign government bonds in case we are surprised by inflation or a weak dollar.

Tactical Asset Allocation

Our asset allocation approach has continued to be refined over time, and part of that refinement is a clearer differentiation of our strategic (long term) allocation and our tactical (shorter term) allocation. Every investor wants high returns with low risk, but our clients are wise enough to know there is no free lunch. It is impossible to accurately time every wiggle in the stock or bond market, but we believe we can improve on a simple buy and hold strategy.

We attempt with our strategic allocation to identify big shifts in the economy or markets and over-weight or under-weight sectors based on multi-year trends. For example, as discussed many times we have expected low returns from investment grade bonds. As noted, there is a place in a portfolio for them, but we have under-weighted investment grade bonds and looked for alternative strategies to enhance returns without taking on too much risk. This has been a part of our strategic allocation for years.

The goal with tactical allocation is to shift a small part of the portfolio every month or two to catch shorter term trends. There are obviously tax implications of making changes more often. Fortunately, transaction costs have become less and less of an issue since we often use no transaction fee ETFs, and the brokerage firms have been competing to drive commissions to almost zero. Schwab and Fidelity are now charging only $4.95 per trade.

Some tactical positions are included in every client portfolio, but some clients want an even more active approach to tactical asset allocation. Each client should work with their Advisor to discuss the extent to which they would like this included in their portfolio. The tactical allocation sleeve might represent 10% or 20% of a portfolio, for example, and ideally might be in an IRA to avoid realizing taxable gains.

David Eads is leading our tactical strategies, and he recently provided this summary of our recent positioning:

CFM – Monthly Tactical Model Update

We are reducing stocks, taking profits, and hedging against a near-term shallow correction. CFM reduced stock allocation down to very mildly underweight stocks (-1 on a scale of -10 to +10). Over the past 3 months we were neutral stocks vs. bonds.

March's tactical trades increased allocation to core international stock holdings and reduced the allocation to core US holdings. CFM also added a small cap US dividend growth ETF that should excel in a rising interest rate environment.

Internal data suggests a longer term overweight to stocks is advised, however excessive optimism is beginning to work its way off. This should lead to a price correction in stocks.

CFM will add to stock allocation (up to +5 on a scale of -10 to +10) once the pessimism in stocks is strong again.

CFM's Tactical Model strongly outperformed its benchmark in 2016, and did so with less volatility than the benchmark.

Sentiment Composite & Crowd Sentiment Polls show the crowd is still too optimistic on stocks.

Relative to a global benchmark, CFM's tactical positioning is overweight US Stock. High-Yield and Emerging Market Bonds are again heavy fixed income overweights.

According to Sentiment models we follow, we hit a peak in optimism recently, which typically indicates a peak in stock prices over the near-term. This gives us the data we needed to get slightly more protective ahead of a possible correction.

For those of you who have been patiently waiting on the sideline with cash to invest: we are now getting closer to an opportunity to invest that cash. Bonds have sold off again recently, and stocks may present a buying opportunity soon! We're keeping a close eye on better entry points & risk / reward statistics to deploy your cash.

Financial Planning Comments

Barbara Lommen
Financial Planner | Advisor

Retiring is <u>not</u> just about <u>not working</u>

On average, 10,000 baby boomers are retiring every day. Reaching the decision to retire can be a process riddled with worry and anxiety and for many people the transition from building up retirement savings to spending down that nest-egg is scary. How do you know when you can afford to retire?

We can prepare a detailed financial plan for you that will help answer this question.

The first planning phase addresses the following basic factors:

What are your retirement assets? We define those as all of your investments and other assets minus your debts, excluding your primary residence.

What do you expect your desired lifestyle in retirement to cost? What are essential living expenses and what are nice extras? Here we go into great detail separating out expenses that are inevitable and that are subject to a higher rate of inflation, such as health care. The level of your expenses in relation to your assets is key to the plan?

What are your sources of income in retirement: will you have rental income, pension, or annuity income? What would be your best strategy for taking social security and when and how should you take your required distributions from your retirement accounts?

Is the risk of your investment portfolio appropriate for your situation or are you able to meet your retirement goals with a portfolio that is less risky?

What is the legacy you hope to leave and what is the best way to accomplish this? Would it be better to gift to your children or favorite charity annually or posthumously?

What are your family circumstances: would you want or need to help parents in their later years, pitch in to help your children to buy their first home, or fund some of the educational expenses for children or grandchildren?

What if you need continuing care at the end of your life?

Achieving the level of financial independence that allows you to retire is a significant and important milestone. But retirement is not just about not working – it is also about figuring out how you are going to spend your retirement days. How you will stay stimulated, socially active and fulfilled? Research shows that people who retire successfully tend to have spent some time figuring out their answers to these existential questions. Here too, we are glad to be a sounding board.

SRI / ESG Investments

Jordan Kunz, CFA, CFP®
Financial Advisor

Pick up a recent copy of *Barron's,* the *Wall Street Journal*, or the *Financial Times*, and you're bound to run across a headline with words straight from the menu of a trendy concept restaurant in Boulder. Words such as sustainable, local, ethical, responsible, green. If you don't know your ESG from your MSG, consider this a crash-course into the latest iteration on the decades-long march towards allowing investors to align their financial goals with their values through sustainable, responsible, impact investing (SRI). To extend the metaphor – to put your money where your mouth is.

SRI investing has gone by many names over the years. You're likely familiar with socially responsible investing or the concept of sin stocks. Why the name change? The sheer quantity of strategies and approaches overwhelmed the narrow scope of the traditional definition. An exponential rise in academic research over the last twenty years, better company reporting, and increased investor advocacy reached a tipping point. U.S. SRI investments grew 33% since 2014 and now represent over $8.7 trillion in assets – still leaving us well behind the curve of the Europeans, who hold twice as much in SRI strategies.

An entire cottage industry of data providers and ranking systems now makes it possible to select companies with the best environmental, social, and governance (ESG) scores versus previously only screening out undesirable holdings (industry jargon: positive screening vs negative screening). Or to raise a red flag when companies start to slip in the rankings like Volkswagen did in the months before the emissions scandal. One caveat: there are no agreed-upon rules for determining how each score is calculated between the various providers. With so much growth, we expect this to stay unresolved for the foreseeable future.

Wall Street has taken note of the SRI upswing with a cavalcade of new products and acquisitions of niche managers to bolster their bona fides. While we've customized client portfolios for SRI goals on request for many years, the improvement in SRI data from our existing research providers and potential new ones is a significant and exciting enhancement to our process. If you're interested in learning more about SRI investing or know someone who would be, please let us know.

The Last Word

Rick Lawrence
President & CEO

You can get a sense of the stimulating discussions we have around here by reading Brad's section of this newsletter. We have our eyes on the markets, economic indicators reflecting current and projected conditions, measures of the inclinations of business leaders and consumers about their future investing and consumption activity, and of course, the unending news from Washington (real and fake). These are definitely times for thoughtful investing choices.

We are working to further develop our menu of investing strategies by allocating resources, including dedicating Jordan Kunz's time, to enhancing the sophistication and scope of our ability to provide socially responsible investing alternatives. This is an exciting project for us, and one that we have engaged in in direct response to requests from clients.

Barbara's piece on planning for retirement is a good review of a number of the different considerations that go into a good financial plan. There are many tools out there to help you make calculations about retiring, but we believe working with an experienced Financial Planner makes a difference. It is not the tool, it is the operator.

When we work with you we can build in special assumptions about continuing income from part time work, planning to fund children or grandchildren's education or household startups, allocating money for travel and other discretionary activities, and anticipating variable market performance in the future. This is important thinking for all of us. Don't forget, financial planning is included in your asset management fee with Colorado Financial Management.

A last note about financial planning. Gary Powell, who has led our planning unit for the last several years, will be trying retirement himself, starting this Spring. We have arranged with Gary for continued work together, though on a less structured basis, providing the firm and our clients continued access to his expertise and estate planning skills even though more of his time will be taken up with new tools - - relating to landscaping and painting. Gary has been a part of our company for 8 years, and in addition to being chiefly responsible for building our planning expertise has been a key contributor to investment strategy discussions. We are proud to have had an association with Gary, and look forward to a smooth continuation as he becomes 'Of Counsel' to borrow a term from the legal industry.

Finally, we end this note as always, with a thank you to all of you for your business and continuing loyalty to our firm. It is rewarding for us to be in this business, and we are grateful for the chance to be in a position to help you with your financial choices.
- Rick

Many happy returns,
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