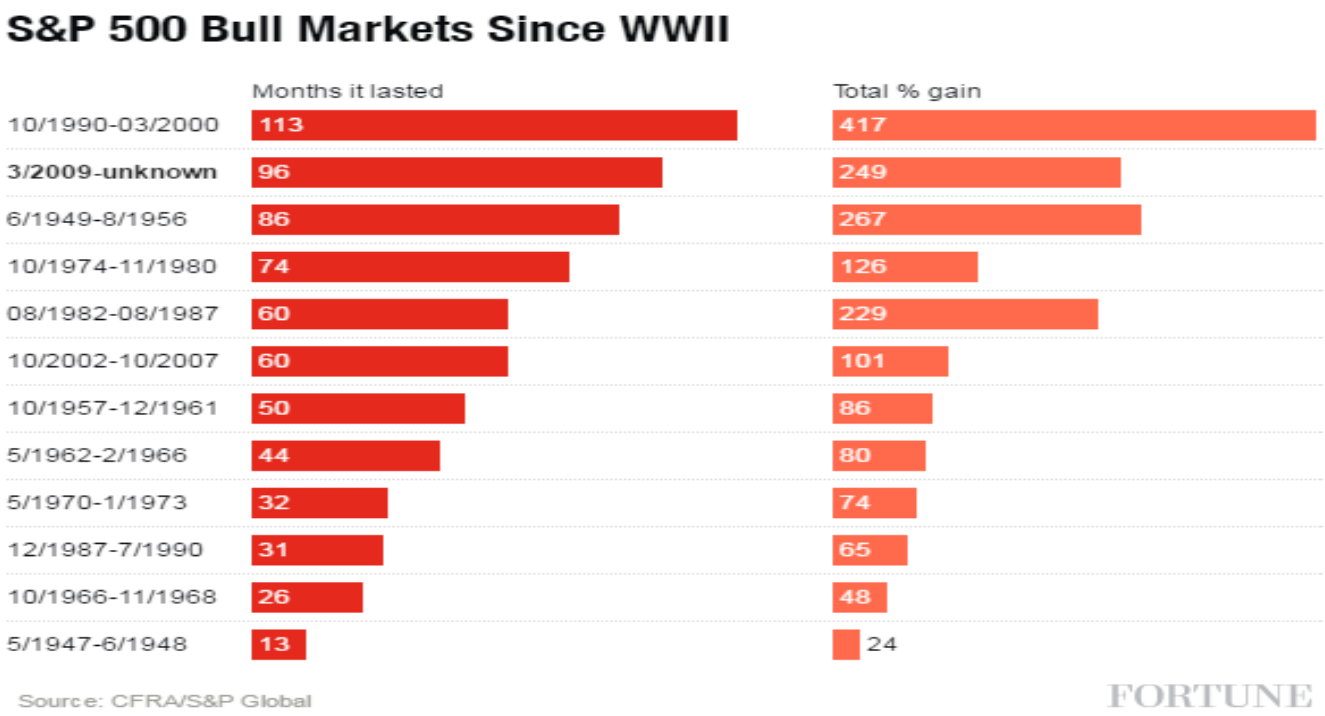
HAPPY 8TH BIRTHDAY, BULL MARKET! WHAT'S NEXT?

Four reasons to "Love" the market at these levels, and four reasons to "Leave" it!

Jay R. Penney *CFP ®, CFA ®, AIF ®*
Chief Investment Strategist for Ashton Thomas Private Wealth

Earlier this month (March 9th), the Standard & Poor's 500 Index, a "proxy" for U.S. stock markets, celebrated the eighth anniversary of the end of its most recent "bear market" decline (Source: www.marketwatch.com/story/the-unrelenting-stock-market-bull-run-demands-some-respect-at-its-8th-anniversary-2017-03-09). Its chilling effects still fresh in many investors' memory, the bear market that ended eight years ago will long be remembered as a nasty side effect of "The Great Housing/Credit Crisis". The stock market's violent decline took just seventeen months from start to finish, but it took (-57%) of the market's capital as well (Source: www.marketwatch.com). Since its merciful end on March 9th, 2009, when the Index closed at a meager 676.53, investors have enjoyed an uninterrupted "bull market", and at the close of the market last evening, the S&P 500 Index sits +249% higher than its start.

As the chart below reveals, at 96 months in duration, the market's current advance is now the second longest since the end of World War II, behind only the nine-plus year run it had during the last decade of the twentieth century. It is also the third best bull market in terms of price gains since that time.



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That is a heady advance, and one that leaves many wondering how long (and how far up) it may go, before the inevitable "bear" comes hunting for overconfident and/or complacent investors' capital.

As market professionals, we are asking ourselves the same questions I hear every day on CNBC and other market outlets, as "experts" disagree on many things, including the health and longevity of this bull market. Will it live to see a ninth birthday, or will it end as badly as many others have? As impressive as the gains shown above are, the declines that followed many of them were equally as impressive:

Bear Market Declines (S&P 500 Index) 1929 - Present

BEAR MARKET	CAUSE	DURATION (MONTHS)	PERCENTAGE DECLINE
Sept. 1929 – June 1932	Depression	34 months	(-86%)
May 1946 – June 1949	Post-WWII Slide	37 months	(-30%)
Dec. 1961 – June 1962	Cold War Jitters	6 months	(-28%)
Nov. 1968 – May 1970	Recession/Inflation	18 months	(-36%)
Jan. 1973 – Oct. 1974	Oil Embargo/Inflation	21 months	(-48%)
Nov. 1980 – Aug. 1982	Stagflation	21 months	(-28%)
Aug. 1987 – Dec. 1987	"Black Monday"	3 months	(-34%)
Mar. 2000 – Oct. 2002	"Dot.com Bubble"	30 months	(-49%)
Oct. 2007 – Mar. 2009	Housing/Credit Crisis	17 months	(-57%)

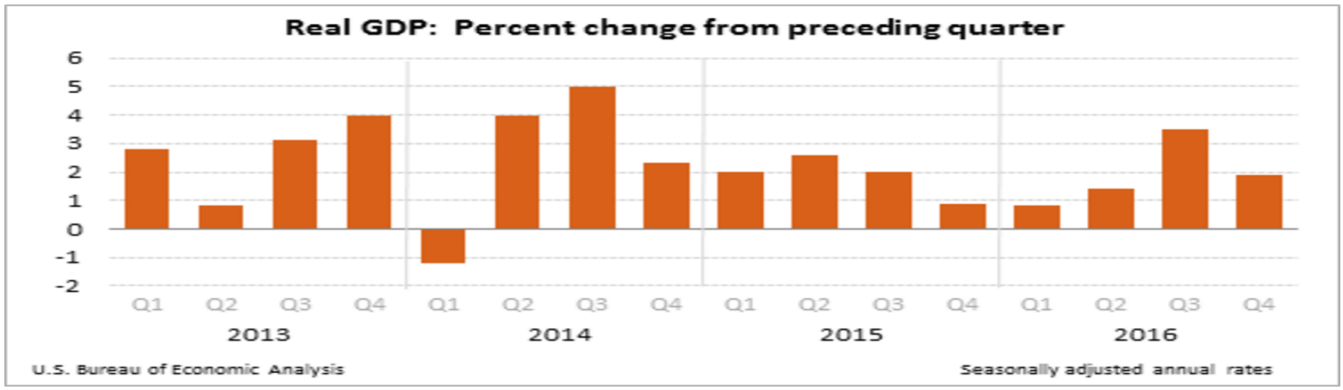
Source: http://www.nbcnews.com/id/37740147/ns/business-stocks_and_economy/t/historic-bear-markets/#.WMRQpFXythE

The data above tells us the "average" American bear market lasts 21 months, and takes (-44%) of the market's capitalization with it. While the causes of bear market collapses are typically *economic* in nature (i.e. stagflation, recession or depression, or economic market disruption), bull market prognosticators are pointing toward *improving* economic data here in the U.S. That said, bear markets are sometimes triggered by concerns about excessive valuations ("*irrational exuberance*"), and/or geopolitical risks, *both of which are present today.*

So, are we approaching another bear market?

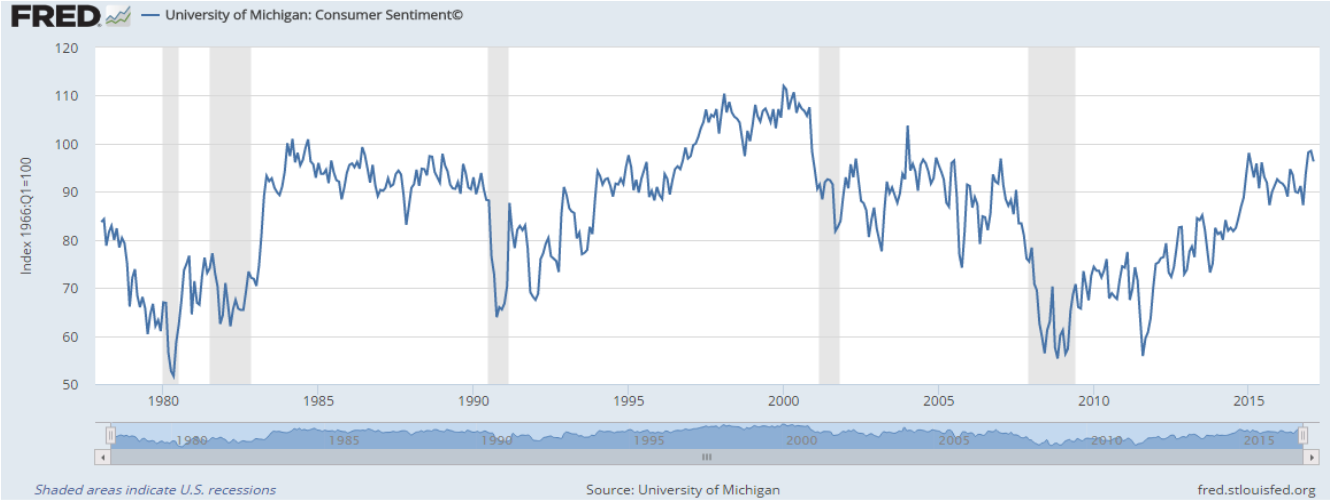
Like most markets at points of inflection, today's stock markets are buffeted by conflicting data, some good, some bad, making it difficult to predict near-term movements with confidence. Rarely do bear markets begin with *universally* bad economic and market data, and rarely do market participants *recognize* these inflection points as bear markets in the making. Today is no different. That said, there are reasons for optimism:

1) *U.S. Gross Domestic Product ("GDP") remains positive, and recession is nowhere in sight.*



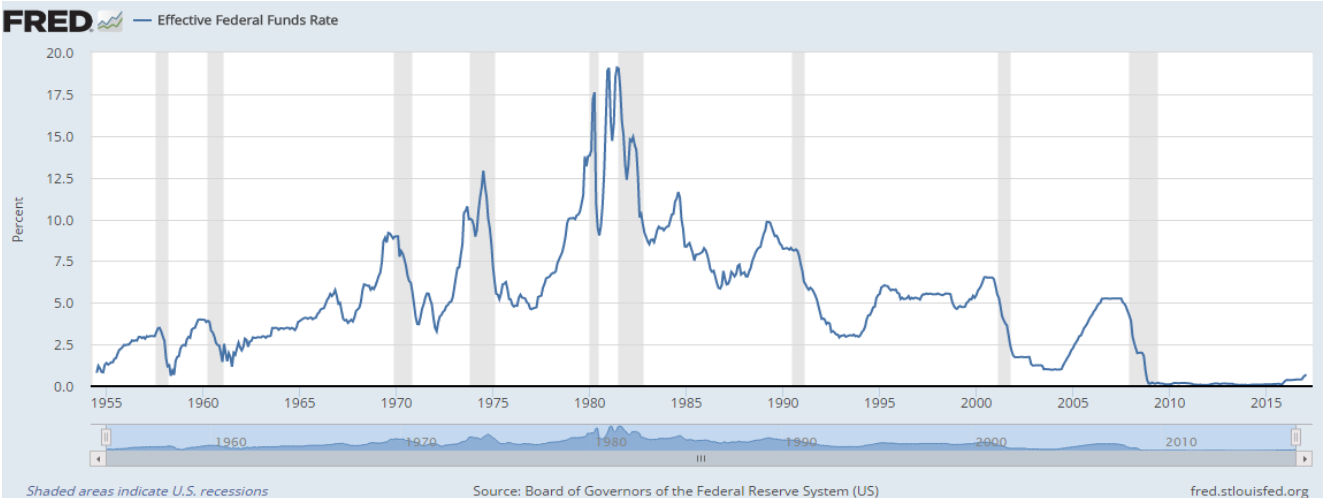
GDP reports in recent quarters have delivered modest, but still positive growth, and estimates for growth in GDP for 2017 range between 2% and 3%. While economic growth of 2% is still modest when compared to the 3.60% average annual growth in GDP seen during the last decade of the 20th Century (1991 – 2000), it is far from recessionary. (Source: Bureau of Economic Analysis)

2) *Consumer Confidence Remains High*



Consumer confidence has been rising relatively steadily since its August 2011 reading of 55.8, and delivered a higher than average reading of 96.3 in February. Rarely do markets collapse when consumers are confident, and spending.

3) *The Federal Reserve is Strongly Hinting at Upcoming Rate Hikes*



The Fed wants to "normalize" interest rates after keeping them artificially low since lowering the Fed Funds Rate to "0% - 0.25%" in December 2008. After seven years tethered to the Fed's every utterance, the market sees the Fed's promise to raise the Fed Funds Rate three to four times in 2017, including the 25 bps hike this week, as *confidence* that the economic expansion is finally strong enough to withstand the headwinds of higher rates. If Chair Yellen and her colleagues, who have resisted this move for years, fearing a recession, are confident that higher rates will not "tank" the economy, investors should take heart.

4) *The "Trump Bump"*

In the 127 days since President Trump surprised the world with his improbable electoral victory (November 8th, 2016 – present) the S&P 500 Index has advanced 244 points, or +11.40%.

Source: Yahoo Finance: S&P 500 Index: November 8th 2016 – March 15th 2017

As a Trump victory became clear on the evening of the election, Dow Jones Industrial Average's futures initially *plunged* 750 points as the results were announced, before fully reversing the following day, and rallying to *gain* +256 points over Election Day's close. (Source: www.marketwatch.com/story/dow-futures-plunge-750-points-on-election-turmoil-2016-11-08) Its added 2,513 points since. Markets are advancing *in anticipation of* the Trump Administration's delivery on campaign promises (aided by a Republican-controlled Congress) to deliver increases in infrastructure and defense spending, reforms of (and reductions to) the corporate and personal income tax codes (and marginal rates), and the repeal and replacement of the Affordable Care Act. If the President and Congress can deliver, stocks could advance even further.

There are good reasons for caution, however, most of which center around valuation metrics:

1) *The S&P 500 Index "As Reported" Trailing 4 Quarters P/E Ratio is "North" of 25*

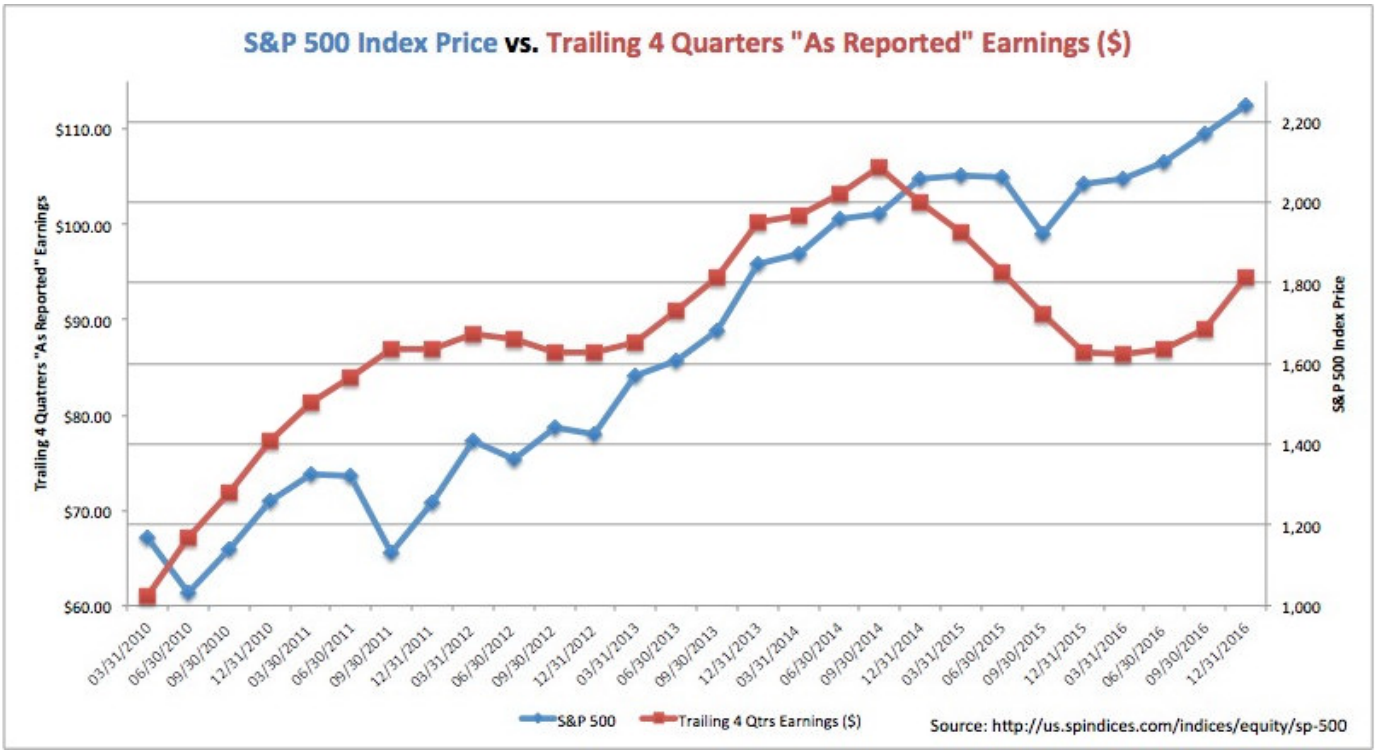
Since September 30th, 2011, when the 4 Quarter (trailing) P/E Ratio was at a cyclically low 13.01 times actual ("As Reported") earnings, the chart above documents the fact that the Index' current level has expanded (exploded?) to 25.10 times the earnings Index constituents *actually delivered* in 2016. Prognosticators describe today's stock valuation levels using terms like, "*elevated*", "*expensive*", and even "*approaching bubble territory*", but nobody is calling stocks "*cheap*" at these levels. The last time the S&P 500 Index' P/E Ratio exceeded 25 was September 2008, just before a (-57%) decline in the Index occurred.

2) *Robert Shiller's CAPE (Cyclically-Adjusted Price/Earnings) Ratio is also in Dangerous Territory*

Shiller's CAPE Ratio – (1880-present)

Source: www.multpl.com/shiller-pe/

Professor Robert Shiller of Yale University invented the Shiller CAPE Ratio to measure the market's valuation. Some consider it a more reasonable market valuation indicator in that it "smooths" the earnings denominator by averaging 10-year earnings numbers, eliminating the fluctuations seen in profit margins during business cycles. The CAPE Index is currently 29.39 times "smoothed" earnings. *This is 77.8% higher than the historical average of 16.73 times earnings.* (Source: www.multpl.com/shiller-pe/) The chart above shows the two previous times *in history* that Shiller's Ratio exceeded current levels (September, 1926 @ 32.6 times earnings, and December 1999 @ 44.2 times earnings), and history warns the markets subsequently fell (-86%), and (-49%), respectively. Oh oh….



3) Corporate Earnings "Peaked" in June of 2014, and have Fallen Since

The **red line** in the chart above represents the 4-Quarter (trailing) "As Reported" Earnings (Per Index Share) of the S&P 500 Index since early 2010. The **blue line** tracks the Index' Price over the period. Historically, the two lines (Earnings and Prices) typically move in the same direction. It makes sense that as corporate earnings grow over time, the share prices of the underlying companies would naturally be expected to grow as well. Moreover, you do see a relatively symbiotic relationship between the two (Earnings and Prices) from early 2010, through September 2014, but Earnings (**red line**) clearly have stalled since, *declining (-18.42%) over the following six calendar quarters (to March 2016), while the Index Price rose +4.43% over the same period.* Earnings have started to improve the past year, rising +9.35% since then, *but the Index Price continues to rise faster*, adding +15.23% since March of last year, expanding the P/E Ratio, and exacerbating the "valuation issue".
(Source: www.us.spindeces.com/indices/equity/sp-500)

4) Geopolitical Risks are Multiplying and Intensifying

The new American President is being severely tested in the early days of his Administration. In recent weeks, the North Koreans have tested many intercontinental ballistic missiles in an effort to develop one that could reach Guam or Hawaii, and ultimately, the West Coast of the U.S., presumably carrying one of their nuclear bombs. Seventy percent of North Korea's 1,200,000 "active" military is stationed along the Korean Peninsula's DMZ, just 35 miles north of Seoul, South Korea, and are backed up by another 7,700,000 "reservists". (Source: www.cnn.com/2015/10/09/asia/north-korea-military-might/) The "Dear Leader", Kim Jong Un, appears to be unhinged, killing rivals internally, including several of his own family members, and is threatening war on the U.S., and on our regional allies, as well. How "suicidal" the country's leader may be is unknowable, but though his country's destruction would be a certainty should he actually decide to *use* nuclear weapons, there is no doubt that he could very quickly inflict significant damage to both South Korea, as well as to Japan. Recently, President Trump told a reporter of an Inauguration Day discussion with then-President Obama on their way to the Capital for Mr. Trump's swearing in. Mr. Trump said he was warned by President Obama that there was one particular "situation" in the world that presented the greatest threat to the homeland, and given the escalation of hostilities in the region in the weeks since, I'm guessing this was the situation to which he was referring.

Additionally, the Administration has troops stationed in over 150 countries today (Source: https://en.wikipedia.org/wiki/United_States_military_deployments), including many serving in harm's way in "hot spots" in Syria, Iraq, Afghanistan, Somalia, and yes, South Korea. Our longstanding support for Israel brings with it enemies throughout the Middle East and North Africa. In the streets of Tehran, Iran's "Supreme Leader" leads the chants of "Death to America". Early this month, Iranian Naval vessels harassed U.S. Navy Surveillance ships passing through the Strait of Hormuz with fast attack boats, clearly provoking the U.S., and testing its willingness to respond. The current Russian President has forcibly annexed neighboring Ukraine's Crimean peninsula, openly threatens our NATO allies, and has displaced millions of Syrian civilians by destroying entire cities, not to mention his meddling in our elections. The Chinese government is becoming increasingly angered by Taiwan's relationship with the West, and its implied "protection" by the U.S., and is literally building islands in the middle of the South China Sea, and claiming territorial sovereignty over previously freely sailed international waters.

Any single one of these geopolitical risks could escalate into an extremely dangerous situation that would panic capital markets worldwide. It may be fair to say that collectively, these global tensions have the potential to present the greatest combined threats the U.S. has dealt with, perhaps, since facing the Axis powers in World War II, and certainly, since the peak of the Cold War in the '70's and '80's.

Given both the "positive" economic and sentiment data, as well as the valuation and geopolitical "concerns" we observe, what is an investor to do? Stay the course? Run for the hills?

I'll begin my answer with an acknowledgement that the future is unknowable, and while past may be prologue, the "inputs" needed for accurate projections (economic conditions, earnings data, geopolitical risks, etc.) change frequently and independently of one another, assuring observers that no two market cycles are exactly alike. We can point to data that would imply further advances, and to others that warn of pending crashes, but conditions have never been exactly as they exist today, so no one can be highly confident in their near-term projections.

Four Reasons to "Love" the Market at These Levels, and Four Reasons to "Leave" it!

Our firm maintains a "tactically defensive" Core/Satellite portfolio design that employs managers and portfolio strategists who employ disciplined and unemotional decision-making tools. All of these tactical and hedged strategists seek to "participate in" a higher percentage of upside market movements than they "participate in" cyclical market declines. I have heard the approach described by a number of them as "*winning by not losing*". The theory is that if managers can avoid taking "large losses", they won't have to spend years digging out of massive holes to rebuild capital.

Here is a "real world" example of how minimizing losses, even if it means limiting gains, can leave an investor better off.

Imagine two hypothetical investors, one investing $1,000,000 in the S&P 500 Index from 2000 – present, and another getting just *50% of the gains*, as well as receiving just *50% of the losses*. Here are the investors' account balances at key cyclical inflection points:

Index Value/Time Period	100% Investor	50% Investor
Bear Market (January 2000 – October 2002) (Index *Declines* by -49%)	$ 510,000	$ 760,000
Bull Market (October 2002 – October 2007) (Index *Advances* by +101%)	$1,025,100	$1,143,800
Bear Market (October 2007 – March 2009) (Index Declines by -57%)	$ 440,793	$ 817,817
Bull Market (March 2009 – Present) (Index Advances by +249%)	$1,538,368	$1,835,999

In addition to ending up with a larger account balance, I can assure you that our hypothetical "50% Investor" would have enjoyed the ride a lot more than our hypothetical "100% Investor" would have. Volatility is unwelcome by rational investors, and especially unwelcome if you have multiple market cycles to navigate your investment capital through during your remaining lives, as was the case during this seventeen-year example.

Because we understand that we can "win by not losing", and we know that avoiding large losses works to our clients' benefit, while allowing them to sleep at night, we are relatively unconcerned about the near-term direction of this rather "extended" bull market. If the markets decline for any reason, we believe our portfolio managers and design will protect our clients' assets. If the markets continue to rise despite its elevated levels and duration, for any reason, our managers will "participate" in some of the gains. Over time, it seems that the best offense is a strong defense.

As always, we thank you for taking the time to read our comments regarding current market conditions, and we welcome your comments or questions.

Jay R. Penney *CFP ®, CFA ®, AIF ®*
Chief Investment Strategist
Ashton Thomas Private Wealth LLC.