

CLEARVIEW

WEALTH SOLUTIONS

This month we answer questions recently posed by clients.

Q & A



- **After an early summer rally, the market seems stuck. What can move stocks higher from here?**

This is an important question that will be determined by several evolving fundamentals. First, more job gains would be a big plus. Non-farm payrolls in August grew only 151,000 but have averaged 220,000 over the last three months. Job gains go a long way in improving consumer confidence and spending which add to both economic growth and profits. Second, investors need

Recently, the odds of a September or December rate hike have risen but multiple hikes this year or early additional hikes in 2017 would be negative. Finally, the election will certainly play a role in stock trends. Investors do not like uncertainty and view Hillary Clinton as the less risky bet. A rise in the polls by Trump could derail stock prices before the election.

- **The Fed looks like it may resume raising rates as early as this month. Can stocks rise in the face of rising interest rates?**

The S&P 500 has risen 12 out of the last 14 tightening cycles since 1958. (Of course stocks do better when rates are trending down). Since the economy is not overheating, the market risks associated with Fed rate hikes are lower than during a normal cycle.

- **You have mentioned that you have positioned the portfolios more defensively. Will that protect me in the next downturn?**

We have grown more defensive on stocks in the recent past mainly due to valuation concerns. The concept of defensive can be described in several different ways. Here are a few components of defensive stocks:

1. Valuations below average, or more specifically, P/E ratios less than the overall market yet with reasonable earnings growth prospects
2. Companies that are less cyclical, or less prone to the ups and downs of the economic cycle
3. Certain sectors, consumer staples and healthcare for example, that have more consistent earnings growth over an entire economic cycle
4. Stocks that have shown less historical price volatility than the average stock

In both our Core and Dividend Growth equity portfolios, many stocks could be described as conservative. For example, about half of the equity portfolios are invested in the consumer staples and healthcare sectors. As a result of that conservative posture, portfolio betas are lower than 1; about 0.90 for Core and 0.80 for Dividend Growth. Note: **Beta** is a measure of projected price volatility. The market has a beta of 1. Numbers less than 1 indicate projected volatility less than the market.

Typically, conservative stocks have an element of protection to them. Often, in bad markets, they fall less than the averages. Our concern today, however, is that the valuations on these stocks are abnormally high. Will they protect portfolios in a bear market? Tough question. Even with stretched valuations, however, we still think these names afford conservative investors the best opportunity to protect principal.

As an aside, one downside of being conservatively positioned is that these lower beta portfolios are likely to underperform in a strong market to the upside.

- **Why are high dividend stocks so popular? Will it last?**

Dividend stocks have had a remarkable run for several reasons. First, many reside in defensive sectors which have been especially popular given investor angst. Second, yield-starved investors, unhappy with bond yields, are flocking to high dividend stocks to earn more income.

These types of stocks have been weak lately because investors fear the Fed may start raising rates shortly. In general, higher yielding risk assets, including stocks, will be hurt as interest rates rise and bond yields become more competitive with stock yields. However, we expect the high dividend yield stock strategy to remain profitable because of the lack of income alternatives in the market and the consistent earnings growth that many dividend stocks provide.

Our focus in Dividend Growth portfolios is not on the highest yielding stocks but rather those stocks that pay above average dividend yields coupled with rapid dividend growth. The goal of our strategy is to build a portfolio with a dividend yield 50% higher than the S&P 500 combined with annual portfolio dividend growth of 9%.

- **How will anticipated rate increases impact my bond portfolio?**

economic growth and employment in the wake of the housing crisis. However, they have also served to inflate financial asset prices. Going forward, as the policies are unwound, there is a risk that the opposite will occur, or at least result in a stagnant market.

Clearly as rates rise, existing bond prices will fall (rising rates have an inverse impact on bond prices). Bond prices are now near all-time highs meaning higher rates are far more likely over time than the inverse. As we do not speculate in bond portfolios and there is growing risk that rates will normalize (rise), we would argue for maintaining a consistent if somewhat shorter dated bond profile.

A far more worrying threat, credit risk, or the ability of an issuer to repay debts, is a powerful theme we discussed last month. In essence, worldwide debt levels have reached an astounding 300% of GDP (an increase of over 40% since 2007 alone) while economic growth among developed countries has been halved in the new century. With rates so low, beginning in 2010, sovereigns, municipalities, corporations and households were induced to raise debt and spend freely. We believe this debt driven spending may ultimately lead to a debt bubble. While it is not yet clear how the binge ends, high debt levels mean the corporate credit cycle is entering a new, more fragile, stage placing high-net-worth investors at greater risk.

Investments in lesser quality bonds now provide a highly skewed risk/reward relationship. These bonds frequently offer little transparency to the underlying credits and even less liquidity assuming liquidation becomes necessary. Therefore **we are avoiding all questionable bonds** and bond-like sectors lacking transparency including high yield and lesser credit corporate bonds, municipals, leveraged loans, non-public REITS, and emerging market sovereign and corporate debt. Instead, we continue to buy only the highest quality bonds, including U.S. Treasuries.

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