



NOTTINGHAMADVISORS  
ASSET MANAGEMENT

**2017 FIRST QUARTER REVIEW**

*There is no training, classroom or otherwise, that can prepare for trading the last third of a move, whether it's the end of a bull market or the end of a bear market.*

-Paul Tudor Jones

Part of what we (“we” = I) get paid to do here at Nottingham Advisors is to make forecasts and predictions about the markets. Now, notwithstanding that I’m on record saying only fools make such predictions, nonetheless it is part of my job. (It’s not often one gets paid to partake in foolish endeavors, but such is life.) The beautiful part of economic forecasting is that these predictions are usually confined to the proverbial economic dustbin within short order, and if you make enough of them, you’re bound to be right eventually. However the endeavor is fraught with risk.

In December of 1996, no less a luminary than Alan Greenspan, then chair of the Federal Reserve, suggested that equity prices were being unduly influenced by *irrational exuberance*. In other words, in his opinion, as the head of the central bank of the United States, stocks were overpriced. From December 6<sup>th</sup> until December 16<sup>th</sup> of that year, the S&P 500 and the tech-heavy NASDAQ both fell about -3%. Maybe people were listening to him after all? Well, from December 20, 1996 until September 1, 2000, as S&P 500 operating earnings grew by 39%, the S&P 500 more than doubled while the NASDAQ gained an astonishing 233%! Expensive stocks got WAY more expensive. Then the bubble burst.

In October of 2005, Ben S. Bernanke, Greenspan’s presumptive heir as head of the Fed, commented before Congress that despite a 25% surge in home prices over the prior 2 years, he didn’t believe we had a housing bubble about to burst. Rather, he indicated, US house prices “largely reflect strong economic fundamentals”. Between November 2005 and June 2006, US home prices would further increase by 2.7%. From July of 2006 until the end of 2011, US home prices would proceed to fall by 26.7%. Hmmm.

So, with that as background, I’d like to go on record stating that by and large, US equities are overpriced. Further, they are likely to stay overpriced until the middle of 2018, at which point they will either correct, or continue to go higher, should the established laws of investing, not to mention the business cycle, no longer apply in TrumpNation. (I’m wondering if SNAP, SnapChat, the latest money-losing tech company to come public at a ridiculous valuation – currently \$26 billion – could branch out from its disappearing texts to typeface that disappears upon reading so these words and prognostications aren’t held against me! In all candor, I am not a huge fan of SNAP, for instead of my children actually reading books, they stare at their phones every waking moment, sending ridiculous “chats” among their friends – until mom goes crazy and absconds their phones...). Okay...Where was I?

Oh, yes, the market. Every market forecaster's challenge is walking the fine line between being "early" on our calls, and being just plain "wrong". I've been both. As the opening quote from legendary investor Paul Tudor Jones indicates, getting the last third of a secular move in markets right is extraordinarily difficult. If our inner "risk manager" mien takes over, we imperil our chances of fully participating in the potential continuation of a rally. If we remain "return seekers" for too long, we're bound to suffer on the inevitable pullback.

As behavioral economists Amos Tversky and Daniel Kahneman famously proved, we all suffer from "loss aversion". We investors prefer to avoid losses versus the potential for equivalent gain. It's in our DNA. However, all it usually takes to embolden most investors is one evening of cocktail party chatter, listening to their neighbor talk about how they bought Amazon stock at \$400 (which, by the way, hit an all-time high as I pen this of \$906 per share – which equates to a P/E ratio of 185x current earnings – but who's counting...) and they'll be right back at the trough angling for more.

But I digress...Q1 is over, the so-called "Trump-Trade" appears to be fading, and we're all wondering whether the Republican Party can quit bickering amongst themselves long enough to move forward with substantive legislation. Politics has never been pretty, but I'm willing to guess that today's dysfunction in DC is far beyond what our founding fathers might have imagined back in 1776. Although I think the caning of Senator Sumner in 1856 might have marked the low point of inter-party Senate relations, I think we're getting pretty close to a new low, as evidenced by the unprecedented "nuclear" option required to get a highly qualified Supreme Court justice approved. There seems to be absolutely no common ground, nor willingness to seek common ground, between the political parties.

When a pro-growth Republican agenda appeared clear and decisive post-election, equity markets responded favorably (they rallied) and bond market responded appropriately (they sold off). Concerns are now growing over whether anything of substance will get done before the mid-term elections in 2018. With that unease, markets are beginning to look more fragile, with volatility picking up and a bid being lent back to the bond markets. Markets detest uncertainty, and the longer the soap opera now engulfing Washington plays out, the less patient investors are likely to be.

We remain cautiously optimistic that a pro-business, pro-growth agenda rises out of DC, but we're not willing to bet the ranch on it. We don't see a large-scale systemic risk looming on the horizon; however, equity valuations have a fairly predictable mean-reverting tendency. At some point, either earnings need to grow 10%+, or stock prices need to fall 10-15%. We're hoping for the former. But in case of the latter, that's why we own bonds: Capital preservation.

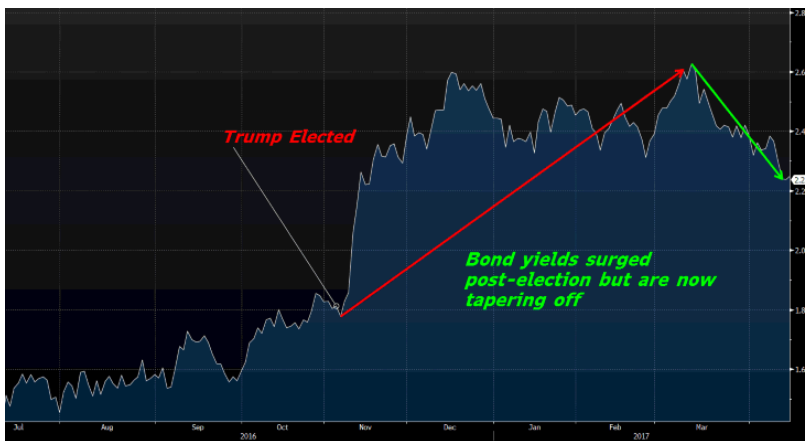
The Fed, having raised interest rates a quarter point in March, is on record as wanting to raise two more times in 2017. Let's hope they do. Interest rates are far from usurious, and the more "normal" they get, the more savers can earn without having to take undue risk. Bond yields should drift higher in 2017, but overseas demand will likely keep a lid on government yields, at least for now. We figure 3.00% on the 10-year Treasury note is a reasonable year-end target.

Speaking of overseas, we like valuation levels in emerging markets and some developed markets far more than the US. After enduring years of maddening underperformance relative to the US, foreign markets are starting to perk up here in 2017. While the S&P 500 returned 6.0% in the first quarter, the MSCI EAFE index (international developed-market index) gained 7.4% while the MSCI EM

index (emerging markets index) shot up 11.4%. A lot of slow growth and bad news has been priced into these markets (in stark contrast to the US), and we're just starting to see some green shoots evidencing growth in many of these long-dormant economies.

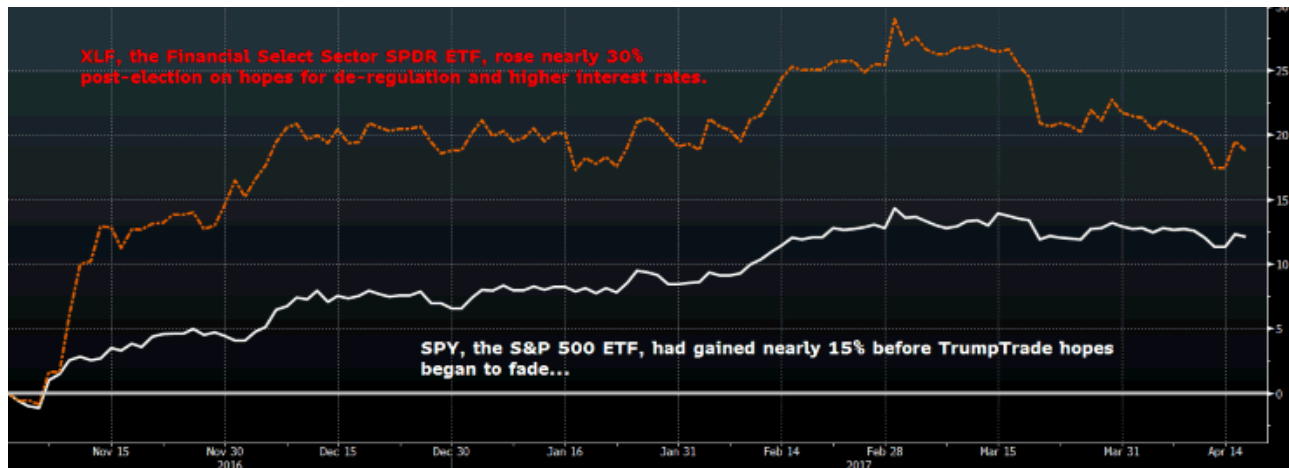
From a cyclical standpoint, it would seem to us that foreign markets are in the initial innings of a longer-term move whereas here in the US, we might be in the bottom of the 8<sup>th</sup> (given that major league baseball recently celebrated its opening day, I think a baseball metaphor might be apropos). While we might go to extra innings here in the US if we get lucky and Congress comes through for us, I'd say we stand an equal chance of the game ending in the 9<sup>th</sup>. The question is whether it will be the top or bottom. Nevertheless, a solidly diversified portfolio remains an investor's best bet for navigating the truly uncharted waters we now find ourselves in.

### The "Trump-Trade" Fading



10-year Constant Maturity Treasury Yield per Bloomberg

*Bond yields surged post-election as newly elected President Donald Trump promised near-term tax reform, infrastructure spending and an easing of the regulatory burden facing corporations. Hopes for a quick solution have faded, however, as Congress dithers over politics.*



XLF vs SPY Post-election thru current per Bloomberg

*Financials sky-rocketed on the back of promises for de-regulation and corporate tax reform. Investors appear to be taking some profits as hopes for near-term relief wither.*

Investors appear caught between an over-valued US equity market and still unattractive fixed income prospects. While we feel there may be some relief to be found internationally, we wouldn't be surprised to see investors push the US market up further. There are little in the way of classic signs of mania in the market, and the past 7 years have proven pretty darn rewarding. Where we are

seeing some signs of excess is in the real estate market. The S&P CoreLogic Case-Shiller Home Price Index recently hit a new all-time high and we do think that the Fed's low-interest rate policy is leading to an unsustainable growth rate in home prices in the US.

Here at Nottingham, we've been establishing a bit of a defensive tilt for the better part of the past year or so. This didn't work out too well for us last year as we trailed our benchmarks a tad; but, in time, we remain convinced that we'll be vindicated. The argument for the "relative" attractiveness of equities versus bonds has limits and we feel we've reached them. A backup in interest rates would be most welcomed by many investors and we do think a mild correction in equity prices will be healthy.

Both the US and global economy remain sound. Our concerns center more around the law of averages – this is the 2<sup>nd</sup> longest bull market on record, while according to the National Bureau of Economic Research the average period of economic expansion since 1945 is 58 months – we're at 96 months currently. But all need not end badly, assuming one is prepared. A little dry powder never hurt as there are quite a few things we wouldn't mind buying at slightly cheaper prices. Patience will be rewarded, as it usually is.

### **In Conclusion**

After another reasonably mild winter here in the northeast, spring is upon us. With that, come renewed hopes for long, hot summer days, along with an optimism that only an abundance of sunshine can bring. Despite some of the sobering tones above, we're optimistic that meaningful fiscal stimulus will be implemented over the coming year or two. Corporate tax reform and, hopefully, repatriation of foreign profits should come about as well. Remember, Ronald Reagan was elected in 1980, and between April of 1981 and August of 1982, the Dow fell nearly -24%! Tax reform didn't take place until 1986, during his second term. I know the "Donald" and the "Gipper" had far different credentials for assuming the Oval office, my point being that inside the Beltway, substantive policy changes tend to take time. Despite the headlines and "fake news" (one of my new favorite terms), good things can and will happen. Stay positive, and enjoy the sunshine.

Happy Spring,

Larry Whistler, CFA  
President/Chief Investment Officer  
April 2017

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