NOTTINGHAM ADVISORS
ASSET MANAGEMENT

Up, Up & Away...

"Too much of a good thing can be wonderful."
-Mae West

With the third quarter firmly in the books, the S&P 500 has now registered a positive quarterly return for the 8th consecutive time, and the 17th in the past 19 periods. It's getting to the point, given the historically low volatility we're experiencing, that even the most skeptical of bears are considering throwing in the towel on this market. It can only go up, right? Even the faintest sell-off in stocks is seen as a "buying opportunity". Margin debt is at all-time highs – even higher than during the tech bubble – despite overall fund flows into equities remaining modest.

The combination of synchronized global growth, improving corporate earnings, historically low interest rates and little to no volatility, has emboldened investors to shrug off high valuations and chase the market ever higher. This couldn't end badly, could it? I'm constantly reminded of *Seinfeld*'s Frank Costanza muttering "Serenity now, serenity now!" while trying in vain to manage his stress. Although I would not characterize us at Nottingham as bearish sceptics, I would admit to a certain unease as we conduct our frequent valuation reviews.

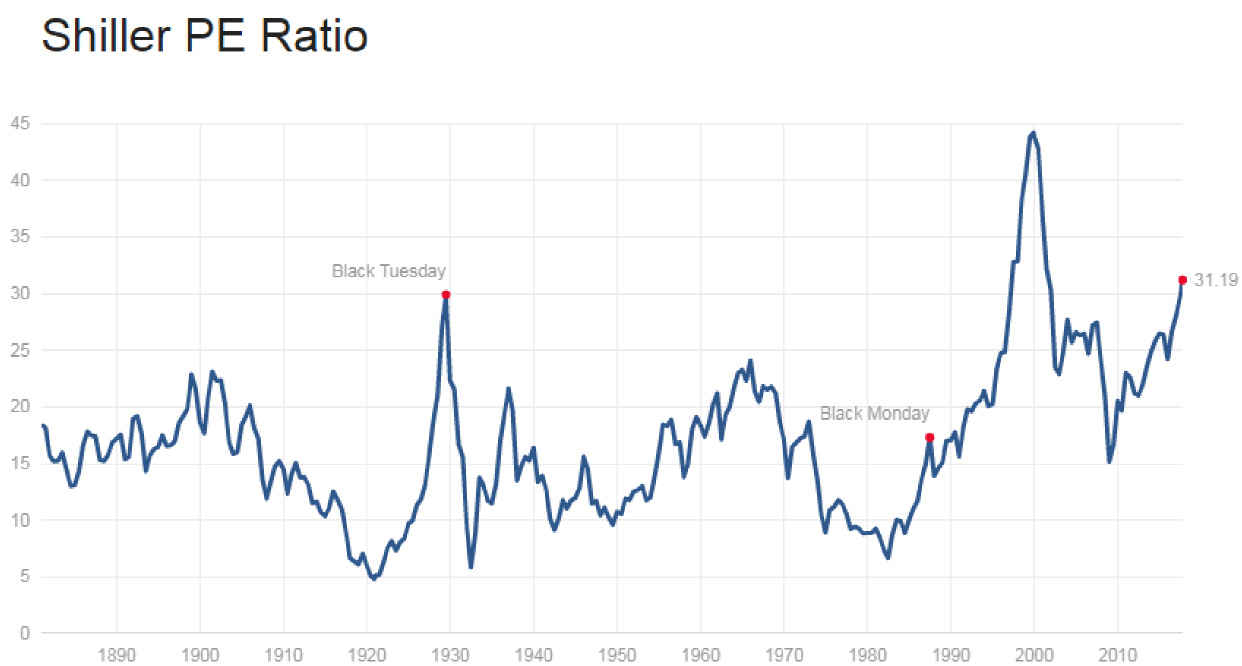
The current price to earnings (P/E) ratio on the S&P 500 is nearly 22x, quite high by historical standards, but not yet at some of the extremes we've witnessed historically. Corporate earnings on the S&P 500 are estimated to come in somewhere around $128 per share in 2017 (up from $119 in 2016), with Q3 earnings reports just rolling out now. The "Trump trade", having all but faded over the first 3 quarters of this year, has stealthily regained some momentum, pushing the US Dollar, bank stocks, interest rates and small caps all higher.

And now we even get the rising prospects for tax reform. Although the rest of the Trump agenda appears in tatters, tax reform has a real shot at happening in the first half of 2018. Lower corporate and personal tax rates, along with the repatriation of foreign sourced profits, could give the US economy a real shot in the arm, sending GDP growth well above the 3% target that the Trump Administration has been touting. The one fly in the ointment, so to speak, could be the US Federal Reserve, whose job it is to keep the US economy in check. We would likely see accelerated interest rate hikes should economic growth start trending much over 3.0%.

As it stands today, the Fed has hiked twice in 2017, taking the short-term Federal Funds rate to a 1.0% to 1.25% range, with the futures market implying an 80.0% chance for a third rate hike in December. Data dependent as always, the Fed is likely looking past the recent unemployment report (showing a 4.2% unemployment rate and a 2.9% YoY increase in average hourly wages), given the data noise caused by the recent hurricanes in Florida and Texas.

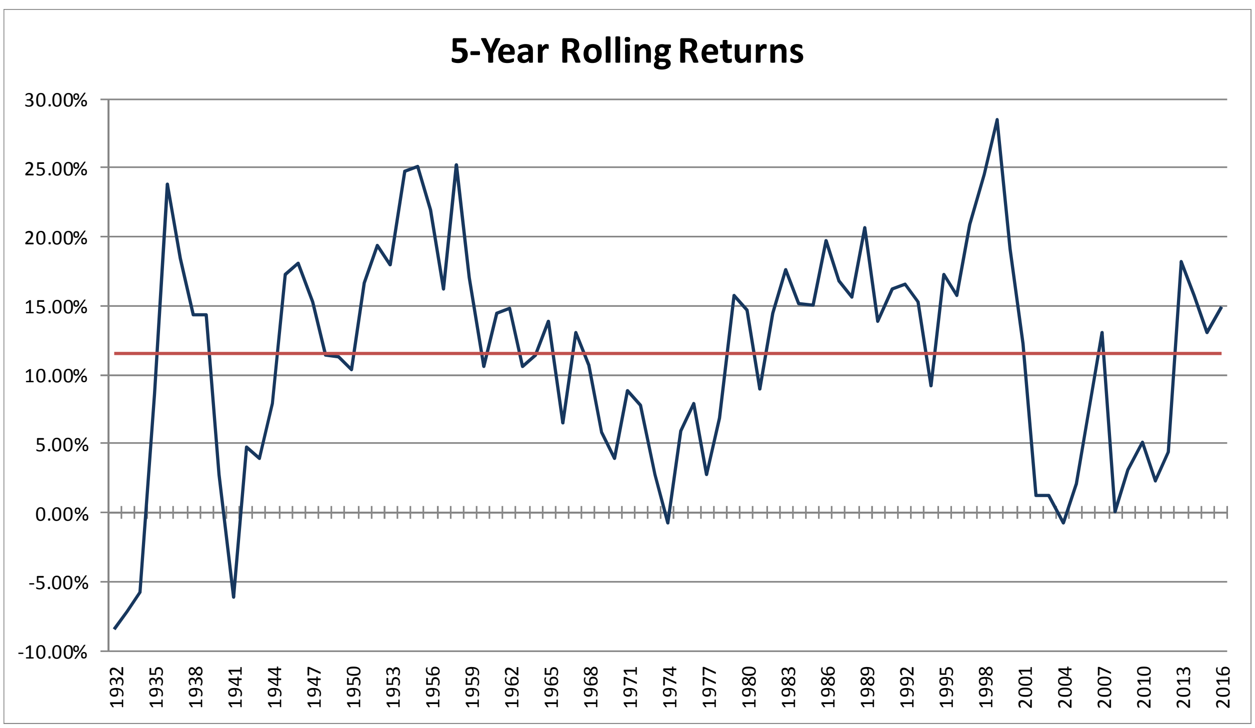
Among the many data points, charts and graphs we monitor, those shown on the following pages are, I think, some of the most powerful – and poignant at this stage. Given the preponderance of noise generated by both traditional and social media - the real-time reporting of every speech, quote and hiccup, as well as the cult of celebrity thrust upon many unassuming characters in our traditionally boring investment arena (who knew that one years' worth of good returns could make one an "investment luminary"?), it's oftentimes hard to see the forest for the trees.

The so-called Shiller P/E, or CAPE Ratio, created by Prof. Robert Shiller of Yale University, looks at equity valuations over a long-term business cycle, taking in the average inflation-adjusted earnings for the S&P 500 over the preceding 10 years. This measure, although lacking in near-term predictive power, stands as probably the best argument against equities currently. Simply put, according to the CAPE Ratio, the only other time US equities were this expensive was during the tech bubble in the late 1990's. While this may not be an absolute reason to sell US stocks, it sure is a reason to be cautious.



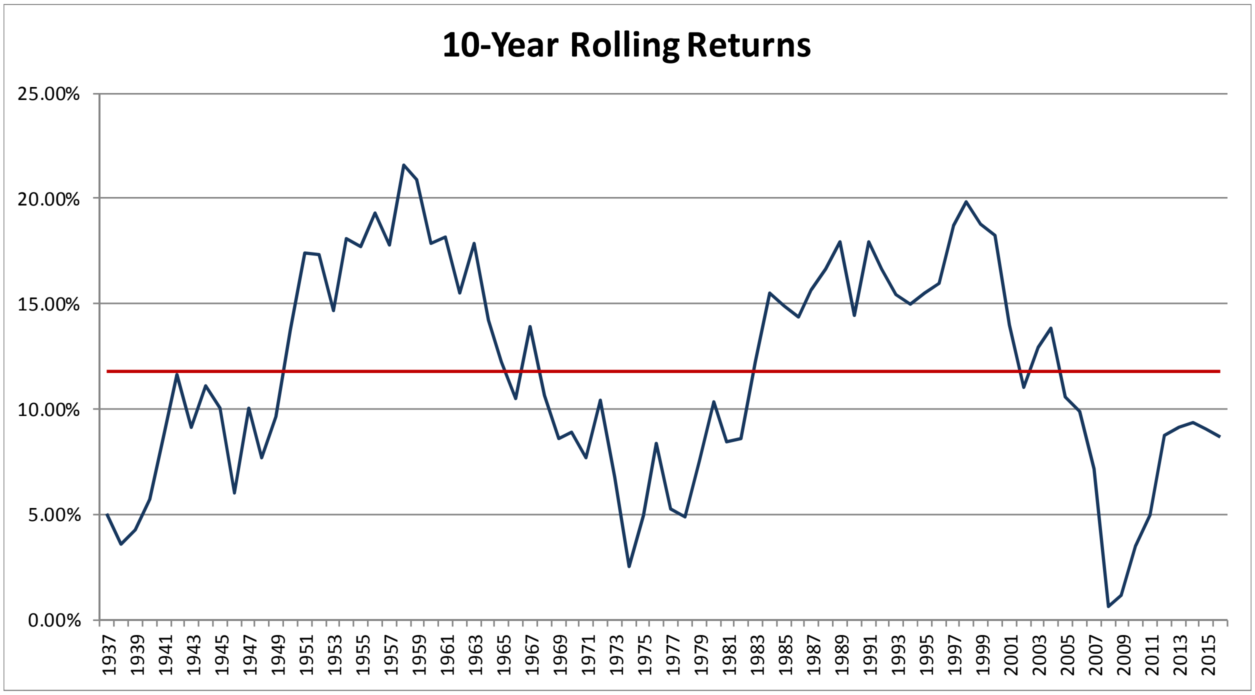
Source: www.multpl.com

If we widen the lens a bit and look at today's annual returns on an historical basis (as the following chart does), we can see a slightly different picture. Looking back at historical 5-year rolling returns for the S&P 500, we're slightly above the average annual 5-year return, but still a ways away from the highs. Despite the strong returns we've experienced following the Great Recession, there's certainly room for equities to melt higher.



Source: Nottingham Advisors

Looking at US equity returns from an even longer perspective, as we're accustomed to doing here at Nottingham, one can see from the 10-year rolling return chart that we're not even back to the average annualized 10-year return going all the way back to 1927. And, the trend pattern, if one were to believe in such things (I'm admittedly on the fence here), would suggest that over the coming decade, annual equity returns could prove meaningfully higher.



Source: Nottingham Advisors

So, what does this all mean as we enter Q4? US equities are fully valued, BUT have room to head higher going into year-end. Within the US, we like financials a lot, industrials and homebuilders merit consideration, and tech continues to impress us. We're sticking with our low-volatility bias and feel the value of this factor only increases as the market increases. We don't mind asymmetric outcomes, especially when the asymmetry protects us on the downside. We're cautious on interest-rate sensitive sectors like utilities, staples and telecom, as we think the Fed will succeed in normalizing the yield curve over the next year or two.

International equities are attractive relative to domestic stocks from a valuation standpoint and have better return prospects (in our opinion) over the coming 3-5 years. We especially like emerging market equities, and have been gradually increasing our exposure to these markets. The combination of lower P/E multiples, greater GDP growth prospects and steady population increases make EM countries more attractive places to allocate capital. Despite the strong returns we've seen in 2017 from these sectors, we feel this could be just the beginning of a longer secular move. A lot will depend on US interest rates and the value of the Dollar, but we remain optimistic.

As for fixed income, we've become more comfortable viewing high quality, shorter duration US bonds as a store of value, and less as a viable income producing vehicle. The properties we are seeking now in the fixed income arena center more around safety and security, including a negative correlation to US equities. Both investment-grade and high yield spreads over Treasuries (the extra compensation an investor receives for taking on credit risk – the risk of default) are at or near historical lows and we don't feel as though investors are being fairly compensated to take a lot of risk in this space. We would rather own Treasury-like instruments that will see their prices rise should equities stumble.

In the so-called Alternative space, we continue to think of gold as an inexpensive hedge against what we see as rising geopolitical risk. God-forbid missiles start flying from North Korea towards the US or its allies, but if they should, you'll want to own some gold. We're also constructive on oil and gas MLP's (master-limited partnerships). We think oil is likely to trade in a range of $45-$65 over the coming year and in a low-interest rate world, we like the 7-8% yields that many MLP's offer. Hedge funds continue to befuddle us (high fees, low returns) while the private equity space is getting very crowded in our opinion. <u>We feel liquidity is very underpriced.</u>

Summary

2017 is on pace to be one of the better years investors have seen in quite some time. Large-cap US equities are up 14% through 3 quarters, while international developed markets are up over 20% and emerging equities have surged over 28%! Most bond indices are positive on the year, with US high yield up 7% and EM debt up over 9%. Real estate, as measured by the S&P CoreLogic US Home Price Index, is up nearly 6% year over year. Why all the positive surprises? You can thank your (our!) fairy god mother Fed Chair Janet Yellen and her merry band of doves known as the Federal Open Market Committee. They have kept interest rates artificially low, and have demonstrated time and again they are in no hurry to see them rise. The profound absence of inflation has given them a great deal of cover we must say.

This low interest rate condition likely won't last forever, though. With a rate hike set for December, and 3 more scheduled in 2018, we will soon be closer to a "normal" fed funds rate than not. "Free" money has proven an incredibly powerful force. It elevates the value of nearly every asset class. "Goldilocks", "Nirvana", "Ridiculous" – pick your term for the past few years from a risk-takers standpoint. They have been amply rewarded. Absent free money, however, asset prices must correct. The prices of existing bonds will fall as newer higher-yielding bonds come to market. The cost of capital for US corporations will rise, reducing earnings and rendering many would-be projects economically unfeasible. Housing price gains will revert to historical norms as mortgage rates rise.

In other words, mean-reversion will take place. And that's not necessarily a bad thing. Absent a severe recession, this can take place in the context of full employment, moderate inflation and steady markets. It need all not end badly. The Fed is committed to sticking the landing on this dismount from a decade of quantitative easing. Their work thus far is to be commended, and we remain hopeful their skill, experience and wisdom will remain on display as the echoes of the Great Recession of 2008 fade away.

Enjoy the Autumn,

Lawrence Whistler, CFA
President/Chief Investment Officer
October 2017

www.nottinghamadvisors.com

NEW YORK OFFICE : 100 Corporate Parkway : Suite 338 : Amherst, NY 14226 : 716-633-3800 : 716-633-3810 Fax

FLORIDA OFFICE : 3801 PGA Boulevard : Suite 600 : Palm Beach Gardens, FL 33410 : 800-281-8974