Haddonfield, NJ
30 S. Haddon Ave
Haddonfield, NJ 08033
P 856-482-8700
F 856-482-0096

Allentown, PA
7540 Windsor Dr, Ste 201
Allentown, PA 18195
P 610-820-0240
F 610-820-5011

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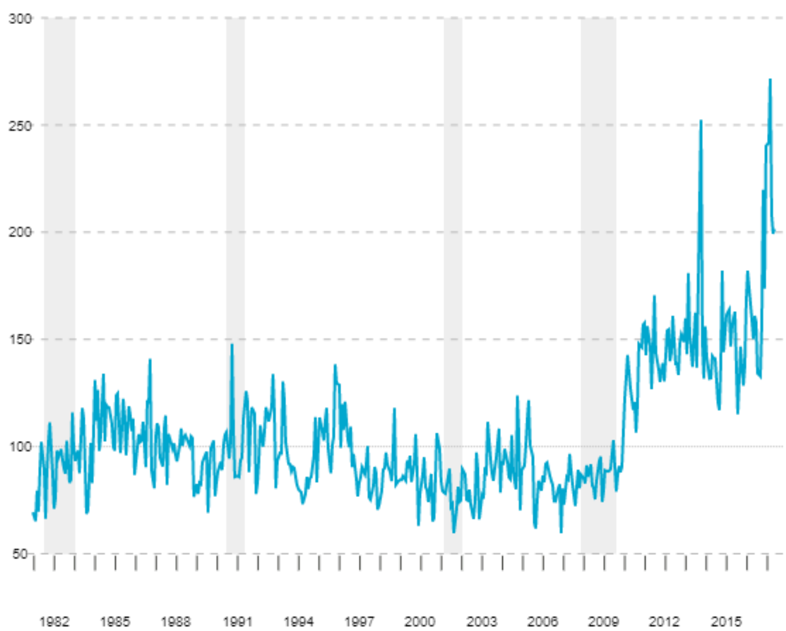
To Our Clients, Partners, and Friends –

Summer is a time when many people put their financial concerns on the back burner for some quality rest and relaxation. Coincidentally, market conditions have been incredibly cooperative in this regard. Conditions for stocks appear to be relatively smooth, illustrated by still-low volatility and major indexes near record highs. Earnings reports have been solid, inflation is low, and the U.S. economy is growing.

Nowadays, it seems that investors biggest question is "what will Donald Trump tweet next?" We believe investment decisions should be apolitical, but there is an interesting phenomenon behind this question. The Philadelphia Federal Reserve has been tracking, for the past 36 years, the degree of political discord based on keyword searches of major U.S. newspapers. Their findings are published in the form of the Partisan Conflict Index[1]. On the chart below, a measurement of 100 is considered "average" –



It may seem counterintuitive, but the stock market has historically risen faster when anxiety is high. During periods of higher partisan conflict, one-year forward returns for the S&P 500 have been 13.2% versus 7.3% when conflict was "below average"[2].

[1] Marina Azzimonti, "Working Paper No. 14-19: Partisan Conflict", *Federal Reserve Bank of Philadelphia*, June 2014
[2] Featured Comment, "Partisanship is Good for Stocks", *Ned Davis Research*, July 5 2017

The previous peak for this indicator was marked by the government shutdown in October 2013 during the Obamacare standoff. In short order, Washington has managed to outdo itself. As of March 2017, we can say with quantifiable evidence that partisanship has never been greater (at least since 1981). True to form, this has correlated with mostly positive economic data.

Political conflict driving the stock market is, of course, anecdotal. A more pressing question is: how can long-term growth be achievable at this point of the economic expansion? One potential catalyst is the housing market. So long as prices don't spike too high, the demographic trend is strong. The age group that typically constitutes first-time buyers continues to accelerate, while baby boomers continue to occupy their homes. That trend is likely to continue until baby boomers reach the average age of death of about 81. The leading edge of the baby boom is currently about 70 years old.

Meanwhile, the number of people currently turning 81 remains unusually small because of low birth rates during the Great Depression. This is creating incredibly low levels of inventory relative to demand. In turn, existing-home prices have accelerated 6.6% year over year, compared with 6.2% at year-end[3].

Global macroeconomic conditions also appear poised to support long-term growth. All the world's top 20 economies are on track to grow in 2017 and world trade is on track to post its highest growth since 2010[4]. Most risks to global growth have receded, as protectionist rhetoric has cooled and election outcomes eased risks of a potential European Union breakup.

Amidst this backdrop, technical indicators show that equity markets have recently been in a sector rotation pattern. Globally, currency and commodity prices are the lynchpin; a weaker U.S. dollar and stable oil prices led to outperformance by international stocks compared to 2016[5]. Domestically, technology and energy stocks have moved lower, while policy changes spurred rallies in financials and health care. These rotations, as well as occasional pullbacks in the overall market, appear to be keeping investor sentiment from getting overly optimistic. This will likely help to prevent a "melt-up" scenario, as slow growth may be more beneficial than fast growth at this phase of the economic cycle.

Below the surface there are developments to heed, with inflation and monetary policy at the forefront. The Federal Reserve has been in sharp focus for good reason. They are indeed in the process of hiking interest rates, recently raising the federal funds rate to 1.25% during their June meeting[6]. However, this is far from the garden variety Fed policy cycle. A "balance sheet normalization program" is slated to begin later this year.

The Fed began adding Treasury and mortgage-backed securities to its balance sheet amid the financial crisis, since which time the assets have ballooned to about $4.5 trillion[7]. The objective of "normalization" will be to shrink the size of the balance sheet by selling these securities through open

[3] Robert Johnson, "Rays of Hope in This Week's Economic News", *Morningstar Institutional Research*, June 24 2017
[4] Jeffrey Kleintop, "Broader Growth, Narrower Risks", *Schwab Mid-Year Global Market Outlook*, June 26 2017
[5] Liz Ann Sonders, "Smooth Sailing for Stocks?", *Schwab Market Perspective*, July 7 2017
[6] Press Release, "Decisions Regarding Monetary Policy Implementation", *Federal Reserve*, June 14 2017
[7] FRED Economic Research, "All Federal Reserve Banks: Total Assets", *St. Louis Federal Reserve*, July 11 2017

market operations. In other words, the Federal Reserve will exchange their bonds for cash. The resulting downward pressure on liquidity will create inflation and increasing interest rates.

It is important to understand that this is not an exact science. But, theoretically, this mix of short-term rate hikes and bond sales allows the Fed control of the entire yield maturity curve. This is important as an inverted yield curve (short-term rates higher than long-term rates) has historically been the one reliable predictor of a recession.

Looking back to 1946, there have been 12 periods of Federal Reserve tightening with rising interest rates. The total return of the S&P 500 was positive in 10 of those 12 periods[8]. Each one, of course, has too many unique factors for a reasonable person to conclude that this next cycle *will be just like the late-1950s*. However, the very low level from which interest rates are rising and the low level of inflation are not likely to choke off the economy, or the bull market in stocks.

We hope you enjoyed our comments. If you have any questions, please do not hesitate to contact us. We welcome the opportunity to discuss our thoughts in greater detail. Thank you for your continued confidence in Planning Capital Management.

Sincerely,

Richard W. Bell, Jr.
President, Senior Advisor

Jay Ahlbeck, CLU®, ChFC®
Senior Advisor

Daniel Brady, CFP®, CLU®
Director of Financial Planning

[8] Schwab Expert Commentary, "Gimme Three Steps…and a Stumble?", *Ned Davis Research*, May 22 2017