SFE INVESTMENT COUNSEL

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Quarterly Commentary

Favorable developments in global economic growth were highlighted by the US posting a higher than expected 3% GDP growth rate in Q2. Earnings were also generally higher than estimates with many companies raising guidance for the balance of the year. Globally, consumer and purchasing manager sentiment remain high. The consensus view is for continued favorable economic and earnings growth into 2018 while bond prices suggest interest rates will remain subdued. On the surface, it's reasonable to expect the current favorable market environment to continue, and it may very well.

We remain cautiously invested in this market expansion which added another mid-single-digit increase this quarter. Overall market returns this year have been about twice the rate of underlying earnings growth indicating that earnings multiples continue to expand from already high levels. Volatility was even less in the third quarter than previously this year, which was already at the lowest levels in more than 25 years. Many suggest this is the result of the excess cash created by the central banks' quantitative easing programs and that in turn has been looking for an investment home.

As we've pointed out in the past, equities remain the most attractive asset class on a relative basis and have been getting new investment flows despite their historically expensive valuations. And since a larger percentage of investment flows are going to passive index or ETF funds, there's much less discretion in the investment decisions - indexes and ETFs invest across the board without regard for the fundamentals of the underlying businesses being acquired. High valuations, excess cash and low volatility suggest investor complacency. A recent cover article in The Economist "The Bull Market in Everything" describes how important low interest rates have been to virtually all asset prices.

October 19th marks the 30th anniversary of Black Monday – when the stock market fell 22% in a single day. Following overnight weakness in Asia and Europe, US futures dropped precipitously that morning triggering computer-driven "portfolio insurance" algorithms into a selling frenzy without regard for price, valuation or fundamentals. Coincidentally, this October marks the beginning of another possibly historic event -- the Fed's attempt to reverse its unprecedented quantitative easing program. We hope this selling $3 trillion worth of bonds (over time) can be carried out without the unintended impact of elevating bond yields much higher than expected.

Our forte is that we are active managers and very client-centric. We buy and sell client investments based on the fundamentals and valuations of the underlying businesses, and on whether it makes sense from the perspective of our clients' long term objectives. We subscribe to Warren Buffett's view to be fearful when others are greedy and greedy when others are fearful.

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