Someone once said about basketball legend Michael Jordan: “You can't stop him – you can only hope to contain him.” The broad U.S. stock markets continued their impressive postelection ascent during the second quarter with just a few minor hiccups along the way. Our portfolios shared in the upside and built on a particularly encouraging stretch of strong absolute and relative performance dating back to the beginning of 2016. As we noted in our first-quarter commentary, assessing risks and potential rewards in the context of present realities will likely yield better results than trying to speculate on what might emanate from Washington. While expectations for pro-growth government policies may have been pushed into 2018 and beyond, the market has responded well in the meantime to double-digit corporate earnings growth, persistently low interest rates and subdued inflation. Who knows – if we actually do see tax reform, deregulation or infrastructure spending, they may prove to be unexpected tailwinds.

For those of us who prioritize fundamentals and price discipline over chasing momentum, it has admittedly been a little frustrating that for much of the quarter (and the whole year, for that matter) only a handful of large growth stocks have been responsible for most of the gain in the S&P 500 Index. We had hoped that 2016 marked the breakout of a multiyear period of outperformance for value stocks, like we saw in the trend that emerged following the “Tech Wreck” back in 2000. However, when investors perceive that growth is becoming scarcer, they will often flock to those few companies they “know” will still be able to deliver. As economic conditions progressively cooled over the course of the quarter, this flight accelerated. These select few, mostly technology names, also represent some of the largest weightings in the index, so a “virtuous” circle developed as money piled into index funds and drove prices even higher. Although Apple is our largest portfolio holding in aggregate and one of these names, we have never worried much about short-term market trends that can easily reverse. We witnessed a very similar period of narrow leadership and concentration of gains late in 2015, only to see a much more rational environment unfold within months. This is why we have not taken the “if you can’t beat ‘em, join ‘em” approach. As impressive as Amazon is as a company, for example, investors should question whether it makes sense to pay the current elevated price that already discounts potential earnings growth seven or eight years into the future. A number of the trendy stocks did pull back as much as 5–10% toward the end of the quarter and showed not only their vulnerability when the crowd goes the other way, but how they could easily retrace recent gains to become values in the future. We would welcome another shot at owning some of these high-quality businesses at more reasonable prices.

While some of the market darlings consolidated, the broad market strengthened and the percentage of industry groups in an uptrend expanded. Maybe this signaled that, despite waning U.S. economic momentum, the stock market has not abandoned hopes for stronger economic growth later this year and next. Sentiment indicators exhibited widespread complacency, which is concerning since the market has not experienced a meaningful drawdown in an unusually long time. Pullbacks in the first half of the year were the shallowest since 1995, and stocks have not experienced even a 5% correction in more than a year. The strength in the broad market, though, suggests that any selloff would be limited in duration and price drop. Domestic stocks on balance are the most expensive they have been since 2004, but remember that valuations are poor timing indicators. They speak more to future return expectations, which must be realistically and conservatively modeled for in a financial plan, than any useful day-to-day analysis of the markets. While we recognize there is a significantly reduced margin of safety in many cases, we still believe it is appropriate to be invested relatively close to target allocations for now.

Where value in the markets does exist continued to shift frequently. The financials enjoyed a strong postelection run after several years in the doldrums, but paused when prospects for both deregulation and higher interest rates diminished. This stall provided an opportunity to add Citigroup in many portfolios. Citigroup is not only the cheapest major bank by most metrics, but is well-positioned internationally and stands to benefit disproportionately from easing capital requirements (allowing them to pay higher dividends and buy back more stock). Pepsi has been a successful story for us for several years, and we believe we have found additional value in the beverage space through our recent investment in Dr. Pepper–Snapple. They trade at a discount to their peer group and maintain a very attractive long-term growth outlook, led by their recent expansion into health and fitness-oriented drinks. The major beverages companies, with their well-organized distribution systems and focus on spontaneous shoppers (e.g., convenience stores) also appear to be much better insulated from Amazon's competitive threat than traditional retailers, grocery stores and suppliers. Looking around the corner, crude oil's swoon from the mid-$50s per barrel down to the low-$40s may also eventually provide an entry point for patient investors. Energy stocks have gone from being the scourge of the markets to last year's stronger performers and back, all within about 18 months. We have learned from watching such vacillations not to get overly positive or negative when it comes to evaluating what the future holds for certain sectors. As the patron saint of value investing, Benjamin Graham, often noted, the market acts more like a "voting machine" on any given day, yet functions as a "weighing machine" over the long haul. Why not take advantage of this feature to prudently seek exit and entry points?

After investing in some individual European stocks earlier in the year, during the quarter we shifted a little more from what was an appropriately heavy concentration in U.S. stocks over the past five years to a more internationally diversified portfolio by adding to our broad European market exposure and establishing a new position in Emerging Markets. Over the past decade, the S&P 500 has returned roughly 100%, while Emerging Markets have provided negative total returns for the most part. It was not that long ago that the reverse was true and our markets significantly lagged those of faster growing economies overseas. The performance and valuation gap is such that we are likely only in the early stages of a reversion to the mean. More favorable economic growth and corporate earnings trends – combined with the easing of the U.S. dollar, whose previous strength stressed some foreign economies – makes the fundamental case for investing more money outside the U.S. as strong as it has been in some time.

We have lost count of how many years in a row analysts and economists have declared the death of the bond market. Keeping our discipline has proved to be the right call as yields drifted back down after an initial spike late last year after the election, and prices, which move inversely to yields, moved higher to generate largely positive fixed income returns in our portfolios. Yields normally move higher with expectations for stronger growth and potential inflation. Are low yields thus sending an ominous message about the economy at the same time stocks remain near all-time highs? We do not spend a lot of time trying to read economic "tea leaves," but the flattening of both the yield curve and the spread between long-term and short-term interest rates over the course of the quarter bears watching, as it is often associated with slowing growth and either disinflation or deflation. However, disinflation refers to slowing inflation without prices actually dropping and usually does not signal the onset of a slowing economy. If the rare conditions are in place for a period of accelerating growth and tame inflation, then both stocks and bonds may be justified in continuing to rally. Optimism is still justified, but we have to be on guard for a policy mistake, the Federal Reserve raising rates with an economy struggling to launch convincingly. At the very least, the combination of supporting factors that has helped propel stocks – low long-term interest rates and inflation as well as stronger growth in the global economy – are anticipated to remain key factors to monitor over the second half of the year.

We will do our best to keep our discipline and stay sanguine in the midst of often sensationalistic headlines and news flow. Very few are well-served at the extremes – by piling in or going to cash. Consistent, long-term returns with prudent attention to risk management are earned in the margins through hard work, patience and checking emotions at the door.

As always, we greatly appreciate your continued trust and confidence and wish you all the best for a safe, relaxing and enjoyable summer!

Best regards,

The Wise Investor Group

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