

*Economists are often asked to predict what the economy is going to do. But economic predictions require predicting what politicians are going to do—and nothing is more unpredictable.*

— Thomas Sowell Ph.D, Hoover Institution, Stanford University

**A**s Korean missiles flew over Japan, the U.S. stock market shrugged and proceeded to new highs. How can the stock market ignore such grave news? In fact, **the stock market has continued to ignore potentially damaging news, and has closed at 42 new record highs so far this year.** Both the stock and bond markets have been anomalous this year, ignoring news and data that have historically caused markets to stop and sometimes to shudder.

North Korea seems to be one of the largest sources of geopolitical risk. That is not to say it is alone, with Venezuela, an OPEC member, quickly degenerating into a failed state; a non-binding vote to separate Kurdistan from Iran; and a move for Catalonia to declare independence from Spain. Still, North Korea seems to capture the imagination, with a belligerent young leader who has starved and oppressed his people, and rattles sabers in the face of much stronger enemies. **How, you may ask, can the stock market ignore the North Korean threat when they have recently proven their membership in the very exclusive club of nuclear powers?**

**Our take on North Korea is somewhat more pragmatic. Kim may be bellicose. He may be impetuous and unpredictable. He is, however, unlikely to be suicidal.** Should Kim lob a bomb

THE S&P 500 HAS MADE 42 NEW CLOSING HIGHS  
SO FAR IN 2017



Source: Bloomberg, Data Systems

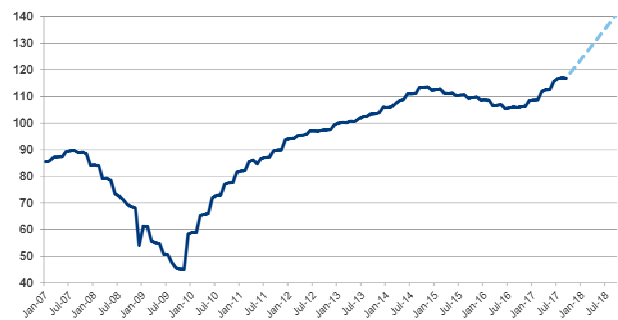


on Guam or Japan or South Korea, he will quickly lose any remaining support from China, and will immediately see his family’s reign end as the United States shows North Korea just how formidable our military power can be.

But in many ways Kim has already proven to be a more powerful foe than previously believed. He has Donald Trump seeing red, and Secretary of State Tillerson reeling. He has proven his military capabilities and must now be given a seat at the big-boy table. It seems likely that he will trade the threat of further nuclear proliferation for some financial aid, and while much of that aid may land in his pocket, he will be elevated to hero status in his home country. By many measures, he is already a winner.

for earnings, and **the stock market has looked through the name-calling and political trash-talking and recognizes that it is unlikely for North Korea, barring some truly suicidal event, to change the outlook for corporate earnings.**

**S&P 500 PROFITS ESTIMATES:  
SOLID GAINS IN 2017 AND 2018E**



Source: Standard & Poors and Bloomberg Data Systems

**In fact, the outlook for corporate earnings remains quite excellent.** The US economy is currently growing at more than 3%, and forecasts suggest that earnings can grow another 8% over the coming 12 months. **As long as the outlook for corporate earnings looks positive, the stock market is likely to continue to shrug off bad news.**

There are several important underpinnings for continued profit growth. First, and perhaps most important, is the fact that **we are witnessing simultaneous growth in all major economies.** Like the US, the Europeans began to recover from the Great Recession, but then Europe became mired in their own sovereign debt crisis. The weaker countries of Portugal,

**10-YEAR INTEREST RATES REMAIN LOW  
DESPITE IMPROVED GROWTH OUTLOOK**



Source: Bloomberg Data Systems

**Remember too that corporate earnings are the sustenance of any bull market.** A belligerent Kim does little to change the outlook



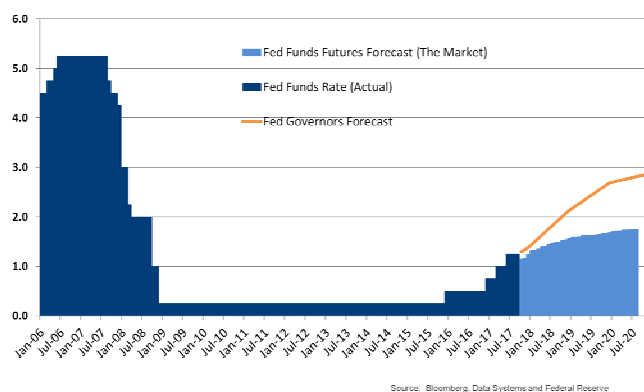
Italy, Greece, and Spain, called the PIGS for short, struggled with their heavy debt burdens, and there was a growing belief that some, or perhaps all of these nations, would decide to leave the European Union (the EU). A collapse of the EU would have dire consequences for all the countries of Europe, and just the threat of a collapse slowed the prospects for the entire continent.

**In June of 2016, the British did what none of the PIGS were willing to do—they voted to leave the EU. In a bit of schadenfreude, the weaker members of the EU could see what a mistake Britain was making. Jobs would leave London causing real estate prices to fall. Employers would shift production to member states within the EU, and British economic growth would suffer. This was a self-inflicted wound but the consequences were quite obvious. In many ways, the British decision to leave the EU gave the other members of the Union a reason to stay. Further, as economic growth continued to improve, Europe began to show strong signs of a recovery that had been absent following the Great Recession. Europe, when taken together, is a larger economy than that of the United States, was finally showing signs of recovering. That will help corporate earnings to continue to advance.**

**Economic growth is not just prevalent in the United States and Europe, but the second-**

**largest economy in the world, China, is also growing at nearly 7%. While this is down from the growth rate of a few years ago, its growth is still the envy of the developed world. Japan, too, is growing at a reasonable clip, and with all the major economies of the world expanding, it is no wonder that projections call for further gains in corporate profits, even as geopolitical risks are prevalent.**

**INTEREST RATE RISKS REMAIN ELEVATED**  
AS OF SEPTEMBER 26<sup>TH</sup>, 2017



**As economic growth continues to expand globally, we find it an anomaly that US 10-year interest rates are actually down as compared with the beginning of the year. In a normal environment, we would expect 10-year interest rates to rise modestly as the growth outlook improves. Likewise, we would generally expect interest rates to trend lower if economic growth was slowing. Why, if growth is solid, have 10-year interest rate actually declined so far this year? It may be due to the fact that US interest rates are higher than those available to**



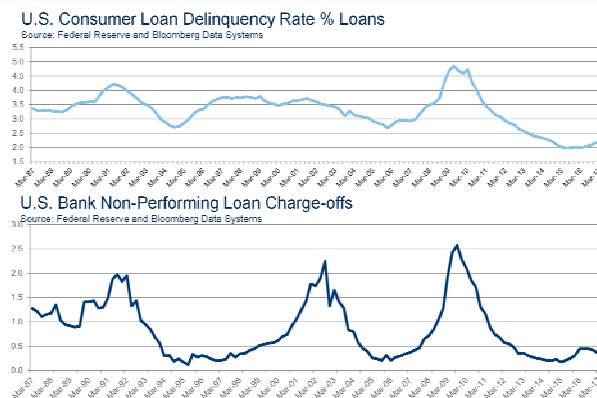
investors in other major markets. Foreign buyers may be rushing to purchase our treasury bonds to earn a yield that is more attractive than what they could earn in their home countries. **Still, we are concerned that the message from the bond market does not support what we see as far as the improved growth outlook.**

Following an unprecedented 7 years with the Fed funds rate near zero, in December of 2015, the Fed finally raised interest rates for the first time since the end of the Great Recession. At that time they indicated their expectations that rates would move continually higher. Despite their forecasts, the next interest rate hike came a full year later in December of 2016. At that time the Fed again announced their intentions for higher interest rates as 2017 progressed. **This year the Fed has raised interest rates twice more, although the Fed Funds rate continues to be significantly below the rate that the Fed governors had expected.**

While some market players expected a further increase in the Fed Funds rate in September, the negative economic impact of the hurricanes in Texas and Florida gave Fed governors an excuse to wait before raising interest rates further. At that time, however, **the Fed did indicate its desire to begin reducing the size of its balance sheet.**

Let’s take a step back in time to review how we got in this position in the first place. As the impacts of the Great Recession remained tangible in the economy, the Fed attempted to do whatever it could to push the economy to a level of self-sustaining growth. **Historically, the Fed has cut interest rates to spur economic growth, but the impact of the recession was so severe that, even with interest rates near zero, the economy continued to sputter.**

FEW SIGNS OF CREDIT PROBLEMS



**The Fed resorted to untried tools to continue to spur the economy. These were referred to as “quantitative easing,”** and the Fed decided that one way it could increase the amount of money in the system was to purchase bonds. The thought process goes something like this: The Fed purchases bonds from a seller. The seller, now flush with cash, does not like the very low interest rates available on other bond investments, so that capital is deployed to build a plant or make an investment that will have a



higher return. Some of that money found its way into the stock and property markets, pushing up the price of assets. With higher asset prices and with more investment, the idea was that consumers would feel richer and would have more confidence to spend, helping the economy regain its strength.

**As the Fed undertook several rounds of quantitative easing (or QE for those acronym-loving Wall Street types), the Fed ended up buying trillions of dollars worth of bonds. (Yes, we did say trillions.) The assets owned by the Fed grew from roughly \$900 billion to \$4.5 trillion.**

Now that the economy is on very solid footing, **the Fed is looking at its swollen balance sheet and has decided that it needs to start reducing those holdings.** It recently announced that it would begin this process by reducing its holdings by about \$10 billion per month, increasing that amount quarterly until it was reducing its holdings by \$50 billion per month.

**This is a very good sign that the Fed has enough confidence in the health of the economy to begin this process. The risk comes from the fact that, like QE to begin with, the reversal of QE has never been done before.** We simply do not know what the impact on the economy will be. If QE helps spur the economy to grow, is it not logical that the reversal of QE

would slow the economy somewhat? In some regards, this is what the Fed is trying to do — they want to see the economy continue on its growth path, but they do not want the economy to get too hot which would cause an unwanted increase in inflation, and would require further action from the Fed.

**So we are embarking on a new and untried tool to control the economy. This certainly suggests increased risk, even as we acknowledge that the Fed could easily cease or reverse its operations if it felt that the impact of this policy was deleterious.** The stock market was able to shrug off the Fed's announcement and continued to march ever-higher. **As of this writing, it is very difficult to suggest that the Fed's policies will have a meaningful impact on the economy or on corporate profits. While that may change in the near future, the market has spoken that it is willing to accept those risks.**

#### **The News is: The News Does Not Matter**

The 24-hour news cycle requires a constant stream of headlines, and the more profound the headlines, the greater the potential audience. That is why the news often leads with "a baby caught in a well" or something similar.

Stock market pundits like to have a reason why the market went up or sold off. Sometimes



those reasons seem very credible and compelling. **The reality is that we often do not know why the market responded the way it did.** Why does the market sell off on one

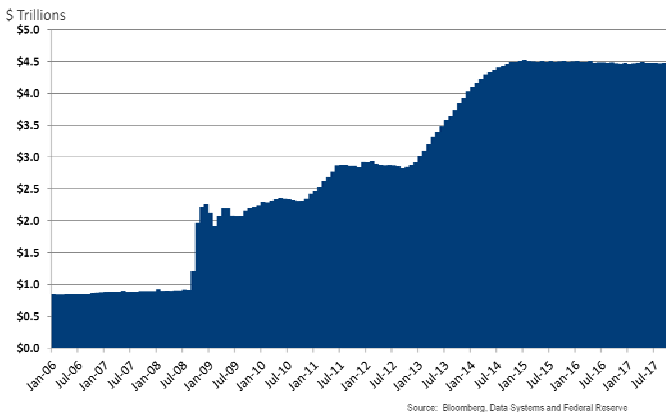
get drawn in to a compelling story, told well, with important implications.

**The market has an uncanny ability to look through the noise that is the 24-hour news cycle.** Sometimes the markets get drawn in, and prices are altered for a short period of time. Often by the end of the day, or within a very short period of time, the market has returned to its senses. Following the assassination of JFK on November 22, 1963, the market was higher by the end of the month. Even after 9-11, and despite the disruption of the market being closed for a week, the market was higher by the end of the year. **News, no matter how important it seems at the time, often has very little long-term impact on stock prices.**

**That is why we rely on data points not on talking heads.** Are credit problems bubbling up? Are bank lending standards tighter? Are Purchasing Manager reports turning down? Are Fed reports negative? Are employment trends changing? Are Leading Economic Indicators advancing or declining? What is happening with commodity prices? With interest rates? With the shape of the yield curve? With the dollar?

Remember that CNN viewership was never higher than it was in the week following 9-11. The news is no longer a public service, but

THE FED'S BALANCE SHEET EXPANDED AFTER THE GREAT RECESSION



employment report but not on a similar report? The answer is that **most of the news does not really matter to the market.** Does the news of Donald Trump Jr.'s emails really alter the picture for corporate profits? Does it suggest a recession is closer at hand? We think not.

We are guilty of having one of those 24-hour news channels on in our offices around the clock. We see the talking heads discuss the ramifications of the Fed's latest pronouncement, the latest on the potential that the GOP conspired with the Russians to alter the outcome of the election, the likely outcome of the next vote on the repeal and replacement of the Affordable Care Act (Obamacare), and everything in between. Sometimes it is easy to





instead is an entertaining and very profitable method for delivering information (useful or not). **Talking heads on tv are not there to help you build a portfolio that meets your needs, but are there to build their brands and talk up their favorite ideas. For us, the data points are the only part of the news cycle that truly matters to the market.**

Last quarter we reviewed our best forecasting tools for determining when the risks of a recession have increased. Those **tools continue to suggest that a recession is not likely well into 2018, and perhaps not before 2019.**

In addition to these indicators, there are many other data points we look at to help us determine when risks are rising. Historically there have been signs of stresses building in the economy well before we enter a recession.

**A telling sign that problems are brewing occurs when there are credit problems in the financial system.** Banking, and a free flow of capital, is like the oil in an internal combustion engine. Without it the system freezes. We look at several indicators to determine whether credit problems are bubbling up. To begin, we look at the interest rate demanded by banks for loans to higher risk borrowers. When lending standards get tighter, the lower quality borrowers are the first to suffer. We can also see this in increasing default rates and in increasing charge-offs for non-performing

loans. **All of these data points remain at or near recent lows, and do not give us any indication that credit issues are mounting.**

Another tool we look at to help us evaluate the risks within the market are how the market is behaving itself. **Warning signs of trouble occur when there are fewer and fewer stocks participating in the market's advance, or when the number of stocks at 52-week highs is**

**INVESTOR PSYCHOLOGY**  
EUPHORIC NEAR THE TOP – DESPONDENT NEAR THE BOTTOM



**declining even as the market is making new record highs. Over the past several weeks the opposite has been occurring. The number of stocks participating and making new highs has been expanding, suggesting the market is on solid footing.**

**We also look for signs of excess speculation as a sign that markets are near a peak. The psychology of investors tells us that investors are euphoric at market tops and are**



**despondent at market bottoms.** This can also be seen in the volume of mergers and acquisitions occurring. When corporate managers are worried they are going to miss out on an opportunity, they frequently engage in merger activity. **We do not see signs of speculation, and we do not see signs of heavy merger and acquisition activity. Take note when your friends are telling you that it is easy to make money in the stock market . It is never easy to make money, and a sign of speculation is when everyone is a maven.** One strategist we followed suggested that when the taxi driver gave him stock tips, it was time to pare risk back.

**We spend time every day and every week looking for signs that risks are rising, even as they may be unseen by many.** This is one factor that differentiates us. **At this time we can say that the signs of risk remain modest,** although we acknowledge that as John Maynard Keynes said, “when the facts change, I change my mind. What do you do, Sir?”

As always, it is important that we know of any changes in your financial situation. Please feel free to call us if you have any questions or comments regarding your investment portfolio.

*Bennett Gross CFA, CAIA*  
*President*

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