ALPHA CUBED
INVESTMENTS

Investment Letter, Q4 2017

October 10th, 2017

Normalization, The Fed, Geopolitics, and a Strong Market

Despite all the negative headlines and general fear of volatility, the market marches onward and upward. We have continued to see growth in corporate earnings and the U.S. jobs market with the unemployment rate down to 4.2% and continued low wage inflation. Please refer to the tables/charts below for a recap of the first three quarters of the year:

	Q1 2017	Q2 2017	Q3 2017	Year-to-Date
S&P 500 Total Return	6.07%	3.09%	4.48%	14.24%
NYSE Composite Total Return	4.58%	3.06%	4.42%	12.54%
Barclays U.S. Aggregate Bond Index	0.82%	1.45%	0.85%	3.14%

	12/31/2016	3/31/2017	6/30/2017	9/30/2017
U.S. 2017 GDP Estimates	2.3%	2.2%	2.2%	2.2%
S&P 500 Earnings Growth Est. (Fwd 12-Month)	23.0%	19.9%	22.1%	19.6%
S&P 500 P/E (Current)	21.18	21.69	21.44	21.66
S&P 500 P/E (Fwd 12-Month)	17.24	18.27	17.56	18.12

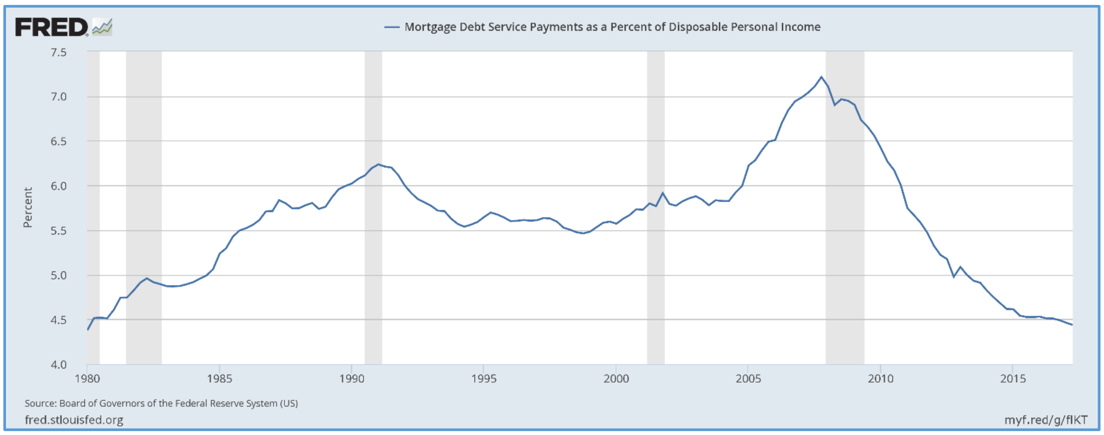
Source: Bloomberg

“Normalization” is an important factor facing the market in the months and years ahead. In the case of investments, “normalization” refers to certain specific monetary parameters controlled by the Federal Reserve Board which can have a significant effect on the prices of equities and bonds. These are the Federal Funds Rate (the interest rate at which banks loan reserves to one another) and Gross Assets on the balance sheet of the Federal Reserve. Normalized values of the Federal Funds Rate and the Gross Assets are not clearly defined, but an approximation might be 3-to-4% for the Federal Funds Rate and $1-2.5 trillion for the Gross Assets. When the financial crisis occurred in 2007, the Federal Reserve lowered the Federal Funds Rate to .25%—its all-time low—and started increasing its balance sheet from $1 trillion to its present level of $4.5 trillion through multiple rounds of quantitative easing.

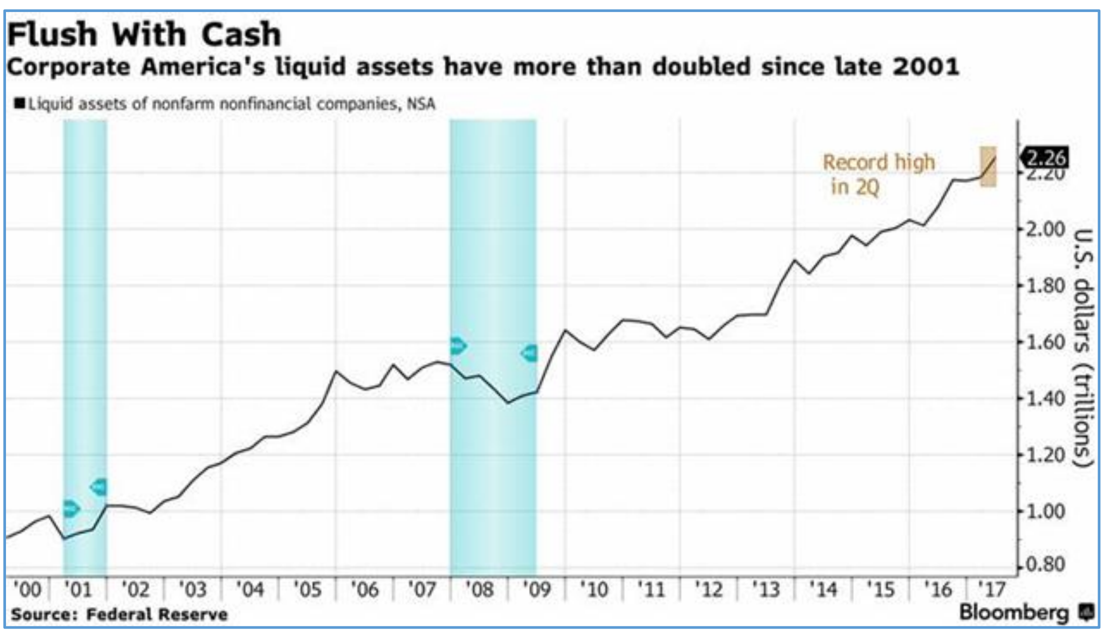
The Fed has signaled that they are confident enough in our current economic environment that they intend to continue their planned rate hikes toward a more historically normal level. According to the Fed Funds futures, the market is pricing in an approximately 80.2% chance (as of 10/9/17) that the Fed hikes rates at their December meeting, which would be their third and final hike of 2017. This comes as U.S. unemployment is at the lows of the decade-long recovery and the international recovery is accelerating.

In addition to rate hikes, the Fed is also planning to begin to wind down its $4.5 trillion balance sheet. To maintain a balance sheet of this size, the Fed has been reinvesting principal payments and funds from maturing securities; to unwind, the Fed is going to limit their reinvestments to only a portion of what matures. To begin, the portion that they let run off will be small relative to the overall balance sheet, but this amount will increase over time. This approach of lowering demand gradually aims to minimize the chance of any outsized effect on interest rates and the financial markets as a whole that this process has historically had. If they ultimately stick to this path, this is a process that will take many years to fully complete.

Valuations remain high and the Federal Reserve is committed to normalizing (albeit slowly), but there are reasons to have confidence that the economy can withstand the potential shocks or volatility that may lay ahead. For example, as can be seen from the first chart below, mortgage debt service payments as a percentage of disposable income is at its lowest level in decades.



This second chart shows the record level of cash held by U.S. corporations (over $2.2 trillion!).



Lastly, this third chart shows that unemployment continues to remain low and just hit the lowest level since the recovery started—4.2%. The consumer and U.S. corporations seem to have a good margin of safety to withstand difficult times if they arrive.

Despite all the risks, it has been a good year in the market so far. We approached 2017 with optimism, coupled with a sense of the need to protect against the risks that are clearly present. We have done well by generally being invested in quality securities but keeping an eye towards larger-cap stocks, higher dividends, lower betas, intermediate bond durations, higher bond quality, a margin of cash in most accounts, or a combination of all these attributes depending on the portfolio and risk tolerance of the individual client (more growth-oriented portfolios will have more aggressive securities). Market valuations remain high and may continue to do so despite some of the negative factors, including escalating geopolitical tensions and the normalization of monetary policy by the Federal Reserve Board. We will maintain our cautious-but-optimistic approach and look to use any outsized volatility to make larger, long-term investments.

Sincerely,

Todd Walsh & the ACI Portfolio Management Team

Disclaimer: Alpha Cubed Investments, LLC (ACI) is a Registered Investment Adviser. This brochure is solely for informational purposes. Advisory services are only offered to clients or prospective clients where ACI and its representatives are properly licensed or exempt from licensure. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by ACI unless a client service agreement is in place.

Data presented herein was sourced 10/9/2017 from Bloomberg.