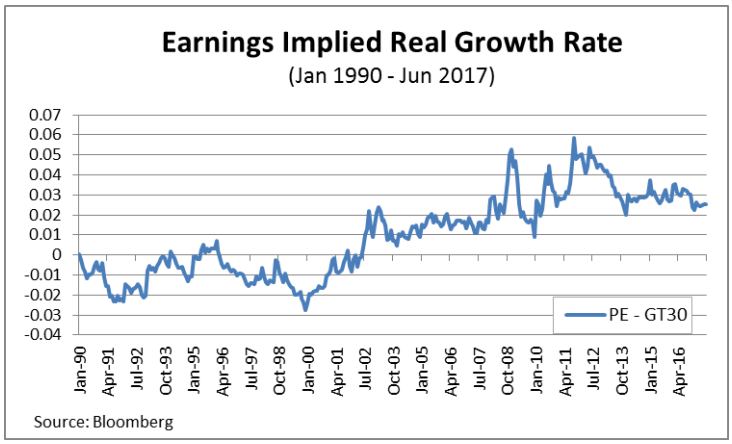
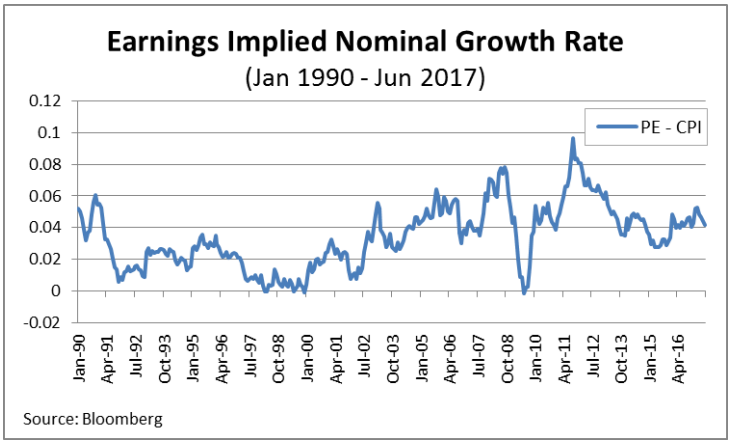
Equity values rose substantially over the last few years and many national and global indexes posted many record closes this year. Over the last five years, the S&P 500 delivered an annualized return of 12.2% despite relatively sluggish economic growth, modest inflation and a confluence of global concerns. By comparison, during that same time period, U.S. bonds returned 2.2% and U.S. high yield delivered 6.9% per annum. Like equities, riskier bonds outperformed government bonds and currently trade at historically tight spreads leading some investors to warn of overvaluation. But are valuations truly excessive?

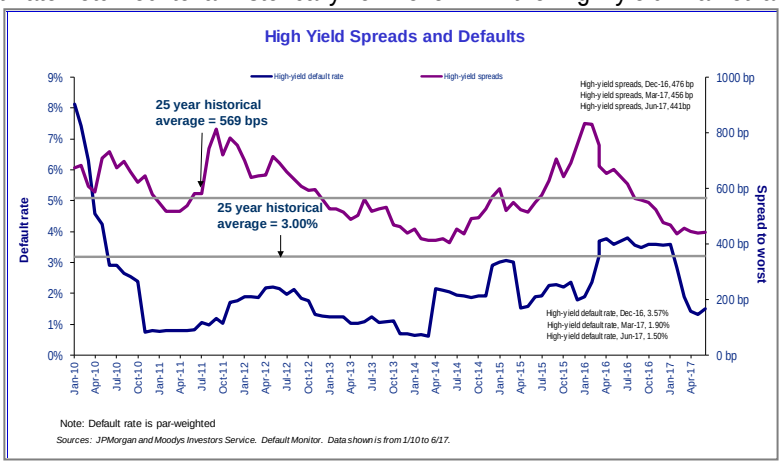
In investing – and other aspects of life – everything is relative. This becomes particularly relevant when one of the relative measures is being artificially inflated, as bonds have been by the Federal Reserve since the 2008 - 2009 recession. One reasonable analysis is to estimate the implied economic growth rate in equity pricing. Using asset pricing comparables, we can invert the price earnings ratio to obtain a market indicated static equity "yield." If we subtract the yield of the long bond, we get the market's implied growth assumption, which, for a broad equity index like the S&P 500, may be considered akin to GDP growth. The graph shows the S&P 500's growth assumption using this measure. At June 30, 2017, the level was 2.5%, eerily close to the average growth forecast of the WSJ Survey economists. Clearly, this is a simplistic measure of equity valuation, but it provides a reasonable assessment of how equity valuations look relative to an alternative long duration credit-risk free investment.



Because of the forward-looking nature of asset prices, an alternative picture can be obtained by subtracting inflation from the equity "yield" to obtain a nominal growth measure. This computation has the benefit of extracting the depressing effect on bond yields of the Fed's quantitative easing policies. The result, in Chart 2 below, does not suggest growth expectations for the S&P 500 are excessive even if, historically, higher inflation rates implied lower nominal earnings growth.



Another area that generates concern is the high yield market as some investors believe spreads do not compensate for the risk. Below is a graph of high yield spreads and default rates. After last year's default-heavy first half (due to faltering commodity and energy companies), the default rate returned to a historically low level. In the high yield market a measure of valuation involves a calculation of post default implied spreads. As noted above, as of June 30, 2017 the BAML high yield index spread was 381 basis points. J.P. Morgan is forecasting a high yield default rate of 2.0% for 2017 and 2018. Assuming a recovery rate of 40% (compared to a 25 year average of 41.2%) on a forecast of 2.0% defaults over the next year, the net investor benefit of owning high yield would be 261 basis points, still comfortably higher than the 115 basis point spread compensation for higher rated bonds.



One of the benefits of the Fed's rate hikes and balance sheet reduction should be the return of market based interest rate determination. The effective subsidization of rates through bond purchase programs can distort market valuations because the discount rate used for project analysis, growth projections, and asset allocation would likely be different without a purchaser whose sole incentive is to lower rates. It is also gratifying to see the European Central Bank and Bank of Japan preparing for the withdrawal of their extraordinary market interventions.

None of this would occur if the economies of the U.S., Europe and Japan were not robust enough to stand alone. The world suffered a great financial shock nine years ago, and it has been discouraging the recovery took so long and required such extreme measures. We believe a return to a world of undistorted and unsubsidized free markets should be good for the global economy and for financial assets. Given where we are, where we have been and where we appear to be headed, high valuations seem reasonably appropriate.

GIA Partners, LLC

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