C&J
WEALTH ADVISORS

COULTER & JUSTUS WEALTH ADVISORS
575 OAK RIDGE TURNPIKE, SUITE 203
OAK RIDGE, TN 37830

865-481-0385 *phone*
865-483-7930 *fax*

WWW.CJWEALTH.COM

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Dear Valued Client,

As some of you may know, my interest in stock investing began in the mid-90's when I was working summers in my father's small real-estate investment firm. When not cutting grass or painting or cleaning up vacant rental properties, I would be in my father's office waiting for tenants to pay their monthly rent. There was a fair bit of downtime, so my father subscribed to the *Wall Street Journal* and the *Standard & Poor's Stock Guide* to help pass the time. Hard labor and 90-95 degree temperatures during several summers made me appreciate the days I got to work indoors. My father was not an active investor in the stock market, but he did follow it closely, studied many great investors, and was curious about how the economy influenced the financial markets and vice versa. Even when I left home for college, he would periodically send me investment articles and journals in the mail to read. He told me in the late 90's when the financial markets were going up 20%+ year-in, year-out like clockwork: "Scott, investing in stocks is not always going to be this easy. The economy and the financial markets are in a sweet spot, but Goldilocks periods like this don't last forever. The real experience you will gain as an investor is when the markets go down." Looking back, my father's words of wisdom were an attempt to make me aware of the inevitable cycles that come with investing and the benefit of maintaining a long-term perspective. Soon after, during 2000-2002, day trading imploded, the mania for internet stocks crashed, and the public's enthusiasm for investing diminished. Lesson learned. I recall my personal story because it reminds me in some ways of current market conditions and how the economy and financial markets continue to grow in a Goldilocks environment characterized by low risk of recession, low volatility, and low inflation. Now that the bull market is in its 8th year, I'll echo to clients what my father told me in the late 90's….investing is not always going to be this easy.

Unlike the late 1990's, however, we are not seeing people quit their day jobs to start day-trading their retirement money. What we are seeing is a proliferation of indexes that are sliced and diced into exchange-traded funds as well as growing numbers of investors frustrated with performance that trails passive indexes.

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A recent cover story in *Barron's* said that there are nearly 6,000 indexes today, up from fewer than 1,000 a decade ago, while the number of individual stocks in the Wilshire 5000 Total Market Index has declined from 7,562 in 1998 to 3,599 today [1]. According to Marko Kolanovic, JP Morgan's global head of macro quantitative research, just 10% of average daily trading volume originates from fundamental investors[1]. As exchange traded funds and passive strategies continue to take market share away from actively managed funds, the proportion of investors that are insensitive to price continues to grow, which inevitably leads to capital misallocation and price distortions. The longer those price distortions persist, the more investors tend to rationalize prices as being normal when in reality it's not always the case. The aforementioned combination of low recession risk, low volatility, and low inflation has produced a Goldilocks environment that has helped these passive indexes thrive. Just like cookies need sugar to taste good, active investment management needs volatility to return before they can begin sowing the seeds of outperformance.

Alongside the changing landscape of investing, we are also seeing a bevy of new companies being created as a result of mega trends in alternative energy, e-commerce, social media, and streaming online content that are seriously challenging traditional retail, media, & even finance. Unlike the late 1990's, we don't have bogus companies that are going public just because they have an internet address and then later disappear. Amazon, Netflix, Tesla, Facebook, and many others are here to stay. As investors, however, we must keep our feet on the ground and ask the basic question of whether the price paid is worth the value received. Perhaps I am old-fashioned or naïve, but I scratch my head when the stock market places a $53.7 billion equity valuation on Tesla when it has yet to earn a dime of profit. Even though I am a loyal customer of Amazon, I also scratch my head when the stock market thinks Amazon is worth $478 billion and trades for 150 times this year's expected annual profit. While the breadth and depth of price aberrations are nowhere near the levels of the late 1990's, these isolated pockets of head-scratching valuations are reminiscent of the late 90's and reflects an investor disposition that is desperately searching for growth companies and will pay any price to invest in them. As these companies grow in market valuation, their weighting in the S&P 500 index will also grow.

In 2000, the S&P 500 was top-heavy in technology stocks with nearly a 30% weighting (vs. 15% historical average). In 2007, the S&P 500 was top-heavy in financials with a 23% weighting (vs. 15% historical average).

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Currently, the information technology sector has an estimated price/earnings ratio around 23x and represents 22.3% of the S&P 500 index, exceeding the composition of the next two largest sectors by 7.8% (financials & healthcare each comprise 14.5% of the S&P 500 Index). Passive index investing works for most investors, most of the time, but when valuations become elevated and when concentrations start to become top-heavy in one sector, that is when the risks and vulnerabilities of passive investing are exposed. As evidenced by the continued inflows into passive indexes, that message is not resonating with very many investors.

Let's quickly recap the market narrative. Last year, investors drove stock prices higher on expectations of fiscal stimulus (tax reform, deregulation, infrastructure spending) that would come from a united Congress and White House. The expectation was that the positive attributes from fiscal stimulus would give the economy a boost and allow the Federal Reserve to continue slowly increasing short-term interest rates without disrupting the financial markets. Both short-term and intermediate term interest rates rose in response and stock price outperformance began to appear across the broader spectrum of financials, cyclicals, & small caps. In 2017, only one aspect of that narrative has persisted, as the Federal Reserve raised interest rates twice (March & June) to a level of 1%-1.25%. Even though policymaking has proved more challenging amidst distractions from Russian investigations and North Korea ballistic missile testing, the S&P 500 index continued to take everything in stride, advancing 9.3% in the first half of 2017. This year's outperformance has come from the sectors that underperformed in 2016, as technology & healthcare sectors are up 17.2% & 16.1%, respectively. Likewise, the sectors that outperformed last year such as financials & small cap stocks are underperforming this year, up 6.9% & 4.8%, respectively.

It has been a bit surprising to see domestic stock prices remain strong amidst policy-making delays. However, these delays have reduced intermediate and long-term interest rates as a result of declining inflation expectations, which in turn has helped keep stock prices elevated and volatility at bay. From an economic perspective, job creation continues to impress with June non-farm payrolls creating 222,000 jobs & the unemployment rate stable at 4.4%. The economy grew year-over-year by 2.1% in the first quarter, industrial production increased 2% year-over-year in June, and both June manufacturing & service sector surveys from the Institute for Supply Management (ISM) were strong at 57.8 and 57.4, respectively (any number above 50 = growth).

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Another piece of positive news came from the Federal Reserve's annual stress test on the nation's biggest banks—all 34 passed the test. Federal Reserve Governor Jerome Powell said. "this year's results show that, even during a severe recession, our large banks would remain well capitalized." Additionally, for the first time in seven years, all 34 of the banks were granted permission to buy back stock and/or increase dividends to shareholders.

If there were any substantive hints of impending weakness for the economy, it would typically appear in the price movements of the junk bond market. Junk bonds are a cross-section of weaker, marginal borrowers that are more dependent upon maintaining access to the capital markets for refinancing needs and are also more sensitive to ebbs and flows in the economy. So far in 2017, high yield bond default rates are at just 1.5% according to JP Morgan and credit spreads over investment grade debt continues to be low (3.73%) and stable.

Moving forward, the biggest change in the market narrative will be seeing how the bond and stock market reacts to the Federal Reserve's plan to begin reducing the size of their $4.5 trillion balance sheet. The plan does not mean treasuries and mortgage backed securities will be sold in the open market, but it does mean that a portion of the principal payments received will not be reinvested back into the bond market. Beginning October 2017, the total number of treasury security holdings will be reduced by $6 billion per month & mortgage backed securities will be reduced by $4 billion per month. The reduction rate will increase by the same amount of $6 billion & $4 billion every three months in treasuries & mortgage backed securities. After a year's time, it's expected that the treasury holdings will decrease at a rate of $30 billion per month and mortgage backed securities will decrease at a rate of $20 billion per month. The goal is to reduce central bank intervention in the bond market and allow intermediate-term interest rates to begin slowly increasing. It's hard to argue against the fact the Federal Reserve's $4.5 trillion balance sheet has increased liquidity, reduced interest rates, and helped boost both stock and bond values. As that process begins to slowly reverse, it would not surprise us to see market volatility slowly creeping up from current levels.

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In closing, thank you for the trust that you place in us. As always, if you have any questions about your accounts specifically, please feel free to give us a call.

Sincerely,

C&J Wealth Advisors

J. Mark King, CFP®
Jeff Loos, ChFC®, LUTCF
Scott Smith, CIMA®

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1: Barron's article on July 10, 2017 entitled Man versus Machine, by Kopin Tan

The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stock's weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance. The MSCI World Index is a market capitalization-weighted index designed to provide a broad measure of equity market performance throughout 23 countries in the developed world.

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Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.