



## U.S. Market Sector Update

13 March 2017

Since the end of last year the broad market has moved steadily into higher valuations. While the focus has been on the magical number of 20,000 on the DOW, and now 21,000, increases in fair value have been more subdued. A 1,000 point move to the upside on a DOW index at 19,000 is just slightly more than 5%. Fair value on the large cap portion of the market has increased 3.3 percentage points or about 3.2%. Market expectations are elevated above fair value, however, that does not translate into a market correction. It is not uncommon for the market to react ahead of fair valuations on both the way up and the way down.

| U.S. LARGE, MID & SMALL CAP |                                |                |           |            |
|-----------------------------|--------------------------------|----------------|-----------|------------|
| Ticker                      | Name                           | Relative Value | Curr Pr   | Under/Over |
| IVV                         | iShares Core S&P 500 ETF       | 105.4%         | \$ 239.15 |            |
| IJH                         | iShares Core S&P Mid-Cap ETF   | 117.9%         | \$ 170.83 |            |
| IJR                         | iShares Core S&P Small-Cap ETF | 113.6%         | \$ 68.30  |            |

It is actually comforting to see the market pause at 21,000 and even dip below the new high water market for a period of time. Market expectations need to get in sync with reality before making a decision as to carry on upward or reevaluate on how long many of the promising new programs need to be in place before real benefits begin to materialize.

In the beginning of this quarter all of the sectors, except Health Care, were ahead of fair value. Industrials was leading the group at 111.5%FV with Health Care at the bottom, just below fair value at 93.0%. Much has changed in 2 ½ months. Industrials continues to lead at 114.5%FV, just 5.5 percentage points away from a cautionary call, but last place is now with Consumer Discretionary. This sector was 5 percentage points above fair value at the end of the year, but has slipped since. Retail enterprises have not helped this sector stay above fair value.

| U.S. LARGE CAP |                            |                |          |            |
|----------------|----------------------------|----------------|----------|------------|
| Ticker         | Name                       | Relative Value | Curr Pr  | Under/Over |
| XLY            | Consumer Discretionary     | 99.8%          | \$ 86.85 |            |
| XLP            | Consumer Staples           | 108.7%         | \$ 55.05 |            |
| XLE            | Energy                     | 106.1%         | \$ 70.01 |            |
| XLF            | Financials                 | 112.8%         | \$ 24.79 |            |
| XLV            | Health Care                | 102.7%         | \$ 75.98 |            |
| XLI            | Industrials                | 114.5%         | \$ 65.84 |            |
| XLK            | Information Technology     | 106.1%         | \$ 53.11 |            |
| XLB            | Materials                  | 108.8%         | \$ 52.11 |            |
| IYZ            | Telecommunication Services | 109.5%         | \$ 32.38 |            |
| XLU            | Utilities                  | 114.3%         | \$ 50.96 |            |

Figure 1: U.S. Large Cap Individual Sector Relative Fair Value Level



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Financials have moved ahead to 112.8%FV primarily because of positive expectations for the banking industry; delivery may be elusive. There are numerous structural and competitive changes in the banking industry that could prove difficult for the enterprises to overcome. A retreat to fair value and below for this sector would not be surprising over the next 12 to 18 months.

Utilities have also advanced despite numerous beliefs that higher interest rates would see investors returning to bonds for more traditional yields. It will take some time for bonds to begin generating normal yields as the Federal Reserve looks for room to increase rates. Utilities are experiencing respectable returns as well at 4.92%.

Large caps are the winners in return so far in 2017 posting a gain of 6.29%. Mid cap stocks are near half of that return at 3.32% and Small cap stocks are giving up some of the gains made from last year ,now posting a negative return of (0.67)%.

Financials is the Mid cap sector leader at 132.6%, but was not the largest beneficiary of positive gains. The big winner was Consumer Discretionary at 116.0%. Before we move on to the other sectors I want to point out that Mid cap Financials are overvalued. Many stocks in the Financials sector, Large, Mid and Small cap, are above the 130%FV threshold. It is a concern that expectations are above the sector's ability to deliver returns. Banking is where the highest overvaluations reside. See the discussion in the industry group for additional details.

| U.S. MID CAP           |                |            |
|------------------------|----------------|------------|
| Name                   | Relative Value | Under/Over |
| Consumer Discretionary | 116.0%         |            |
| Consumer Staples       | 91.8%          |            |
| Energy                 | 87.1%          |            |
| Financials             | 132.6%         |            |
| Health Care            | 113.3%         |            |
| Industrials            | 118.7%         |            |
| Information Technology | 119.2%         |            |
| Materials              | 119.0%         |            |
| Telecommunication Svcs | 92.2%          |            |
| Utilities              | 126.3%         |            |

Figure 2: U.S. Mid Cap Individual Sector Relative Fair Value Levels

Energy gave up the most so far this year falling from very near fair value at 99.1%FV just before the end of 2016 to 87.1%FV here in early March. The energy industry is still experiencing discomfort with changing inventory levels, rig counts and dynamic pricing movements. Overall, Mid cap stocks are the most overvalued at 117.9%FV being driven by Financials and Utilities. The Utility sector has moved through the cautionary level of 120%FV and could easily join Financials in overvaluation territory. A lower level of relative fair value would be comforting for both of these sectors through summer.



Small cap has earned a well-deserved rest, but has also almost fallen asleep this year. In performance, the capitalization category has given up just over ½ of a percent, but has made fewer dramatic individual sector changes than either of its larger brethren. Information Technology and Health Care were both able to move to the upside on fair value while still remaining within fair value territory (80%FV to 130%FV).

Figure 3; U.S. Small Cap Individual Sector Relative Fair Value Levels

| U.S. SMALL CAP             |                |            |
|----------------------------|----------------|------------|
| Name                       | Relative Value | Under/Over |
| Consumer Discretionary     | 103.3%         |            |
| Consumer Staples           | 117.4%         |            |
| Energy                     | 106.6%         |            |
| Financials                 | 123.3%         |            |
| Health Care                | 105.3%         |            |
| Industrials                | 112.2%         |            |
| Information Technology     | 123.5%         |            |
| Materials                  | 117.5%         |            |
| Telecommunication Services | 96.4%          |            |
| Utilities                  | 116.2%         |            |

Industry groups represent an additional level of segmentation of the market and can be considered sub-sectors. Some investors prefer to work with industry groups because the names are easily recognizable and easier to associate with the actual activities of the enterprise.

The year started with 4 industry groups slightly below fair value: Food & Staples Retailing, Household & Personal Products, Media, and Pharmaceuticals & Biotechnology. Two of the 4 still remain undervalued: Food & Staples Retailing and Pharmaceuticals & Biotechnology. Both Household & Personal Products and Media have moved above 100%FV to 105.4%FV and 104.2%FV, respectively. Retailing has moved slightly below fair value at 99.7%FV from an earlier 107.1%FV. Expectations were much higher for retailing as we entered the end of the year spending frenzy. Unfortunately, earnings did not materialize as expected and many of the traditional retailers are admitting to a difficult road ahead. There will be numerous adjustments required to survive in the new environment.

The two largest gainers in relative fair value are Consumer Durables & Apparel along with Technology Hardware & Equipment. Movement in technologically related industries makes sense because increases in productivity depend on advanced use of technology and expenditures are most likely to increase in these areas as expectations overall improve. The industry group is also expected to make advances as many new software enhancements, chip designs and storage, both cloud and local, are being introduced this year. Margins should improve in these and many related areas.



Figure 4: U.S. All cap Industry Group Relative Fair Value Levels

| U.S. Industry Group All Market Cap         |               |            |
|--------------------------------------------|---------------|------------|
| Name                                       | RelativeValue | Under/Over |
| Automobiles & Components                   | 112.0%        |            |
| Banks                                      | 128.0%        |            |
| Capital Goods                              | 116.2%        |            |
| Commercial & Professional Service          | 120.2%        |            |
| Consumer Durables & Apparel                | 115.1%        |            |
| Consumer Services                          | 107.5%        |            |
| Diversified Financials                     | 116.9%        |            |
| Food & Staples Retailing                   | 93.8%         |            |
| Food Beverage & Tobacco                    | 110.2%        |            |
| Health Care Equipment & Services           | 113.0%        |            |
| Household & Personal Products              | 105.4%        |            |
| Insurance                                  | 126.1%        |            |
| Materials                                  | 116.9%        |            |
| Media                                      | 104.2%        |            |
| Pharmaceuticals & Biotechnology            | 98.4%         |            |
| Real Estate                                | 104.1%        |            |
| Retailing                                  | 99.7%         |            |
| Semiconductors and Semiconductor Equipment | 123.3%        |            |
| Software & Services                        | 107.8%        |            |
| Technology Hardware & Equipment            | 114.7%        |            |
| Transportation                             | 106.8%        |            |

Before I end this brief I would like to make some comments on Health Care. There have been both high and low expectations for the industry ever since discussions moved America closer to national health service provisions eight years ago. The discussion is not over and never will be entirely. Related actions will impact the industry and many experts will pontificate about structural changes and even label them a paradigm shift. (Very popular expression in the 1990's by strategic consultants.)

Our view is that the "changes" will keep the health care industry in constant flux resulting in a +/- 5 percentage points around 100%FV. A change from this position would require a non-controversial and uncontested direction in the future of health care. The probability of both conditions is less than 10% so we expect to see much rhetoric, but little change in relative values for some time to come.

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