INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 2ND QUARTER 2018

The ACM Journal

A Test of Patience

For anyone who has ever raised a daughter, it takes only two words to summon feelings of abject terror. Those words of course are: dance recital.

The endless hours, the uncomfortable seats, the numerous awkward dances by those too young or ungainly to be dancers all contribute to one of the longest and most painful days of the year.

We recently went to my daughter Nyla's annual dance recital. This is our third experience, and it never really gets any better. In fact, this year she is in a group that is required to stay for the whole event. In the past we were at least allowed to leave at intermission. Mercifully, that meant we only had to stay for the first three hours.

This year we left home at 2:30 to make sure Nyla got there the required hour before show time. In order to kill time, the boys and I marveled at the overly zealous dance moms' last-minute preening and fussing over their little princesses. We also went to the lobby to purchase some overpriced flowers. You effectively have to buy these flowers, or risk being labeled worst parent ever. Then, we staked out what would be our home base for roughly the next five hours.

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Portfolio Review

While it may come as a surprise, the second quarter of 2018 was actually quite strong for stock investors. The S&P 500 rose 3.4%, mid-cap stocks gained 4.3%, and small-cap stocks returned almost 9.0%. Even REITs rebounded in the quarter for a gain of 7.8%.

Volatility Returns

The year-to-date numbers are more modest, as you can see on the nearby chart, but returns are still positive for domestic stocks. Clearly, volatility has been the big story so far this year. While the stock market has moved higher, it has been a roller coaster ride getting there. News headlines about trade wars, Fed interest rate policy, potential inflation, and other worries have whipsawed stock returns.

We discuss potential future scenarios for U.S. stocks in our *"A Tale of Two Markets"* section of this newsletter. The good news is that stocks could rise 30% from here. The bad news is that they could fall 30%.

International Stocks Falter

After several years of disappointing returns, international stock markets posted nice gains in 2017, and it looked like they were on the road to a significant rebound. Unfortunately, this year tells a different story. Part of the problem is continued economic struggles in many foreign nations, as well as continuing political strife (think Brexit). However, another significant headwind has been the strength of the U.S. dollar. The negative returns for both developed and emerging market stocks shown in the nearby chart reflect returns to U.S. investors. Returns in local currencies were better, and in fact developed market stocks' returns were in line with the S&P 500 for the second quarter.

Still, the emerging markets posted losses no matter which currency you use to calculate returns. These stocks are notoriously volatile, and subject to large swings in reaction to politics and economics both at home and abroad. The threat of a global trade war currently has been bad news for nations with developing economies that depend heavily on exports. On the bright side, international stocks, particularly emerging market stocks, are quite reasonably priced currently. They trade at valuations far below those in the U.S. Over time, those valuation levels matter, and stocks trading at lower levels tend to generate stronger returns.

Alternatives Disappoint

Many of the alternative investment funds we use are off to a rough start in 2018. It is only half time, and there is still time for them to recover, but given that these are more unfamiliar strategies, many clients are concerned about them.

While the returns are generally below what we would like to see, they have

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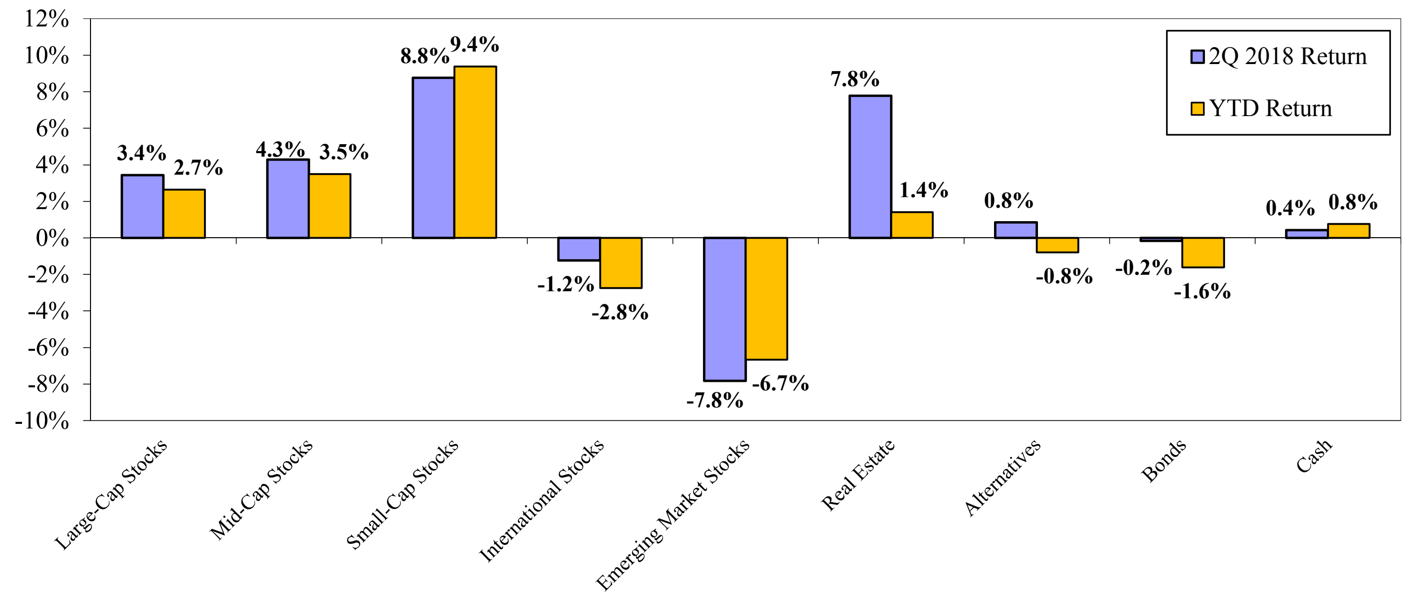
Second Quarter 2018 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

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provided returns over time that are higher than those of the bond market. Because we have taken money from the bond portion of many portfolios to invest in alternative investments, the strategy hasn't resulted in any significant loss of overall return. That said, we expect much higher returns than what we have seen.

While we continue to have faith in a number of the alternative funds in the portfolio, we are reviewing others. We remain committed to the diversification and risk control that alternatives offer, but will of course make changes if needed to improve returns.

Bonds Post Loss

Interest rates rose modestly in the second quarter and more significantly since the start of the year, resulting in losses for the bond market for both the second quarter and year-to-date periods. Rising interest rates, and the threat of future increases in rates have spooked bond investors. Inflation has also been a concern. While still low by historical standards, inflation is starting to tick up by some measures. Rising inflation makes the fixed coupon payments on most bonds less attractive and makes investors less likely to want to buy and hold bonds. As we have discussed previously, the ten-year outlook for bonds is not attractive. However, bonds do offer an important source of risk control, and still have a place in many portfolios. See our article on the possibility of an inverted yield curve for further discussion of the bond market.

Conclusion

Like much of the past several years, diversification was more of a hinderance than it was a help so far in 2018. Bonds and alternatives didn't contribute to returns, and there was no real need to hedge risk as the stock market continued to rise. International diversification was similarly unhelpful. U.S. stocks once again did the yeoman's work of generating returns. Despite the recent volatility, we have been in a golden age for the stock market. It won't last forever, so enjoy it while you can.

Armbruster
CAPITAL MANAGEMENT, INC.

A Tale of Two Markets

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.

- Charles Dickens *A Tale of Two Cities*

Certainly, we're in a divided age currently where the glass could look half full or half empty depending on which side of the political aisle you sit. Unfortunately, that has been true for some time now. The same dynamic is also at play in the stock market. Renewed volatility, high valuations, rising interest rates, and the latter stages of an economic recovery all worry many market participants. Yet, the domestic stock market has remained stubbornly sanguine in the face of these headwinds.

Everyone wants to know where we go from here, and if it is time to get out of stocks. There is of course no way to know for sure. There are concerning signs that the market could roll over from here, but there is also a credible case for the bull market to continue.

One important indicator is starting to flash a warning sign. It is impossible to watch the financial news channels or read the financial papers these days without hearing about high CAPE ratios, death crosses, or some other ominous sounding indicator. Most of these make for good stories but have not been reliable indicators of the market's direction.

There is one exception. The yield curve has been an unusually strong indicator of coming economic recessions. The yield curve is simply the yield on bonds across the maturity spectrum. In normal market environments, longer-dated bonds yield more than shorter-dated bonds. This make sense, as there is a greater risk of default and a greater risk that inflation will ensue during longer time periods.

Yet, when the bond market senses that an economic slowdown could ensue, demand for longer-term notes increases and demand for shorter-dated notes decreases. This is because investors want to lock in today's rates, which they believe could fall in the future if the economy slides into recession.

Interestingly, an inverted yield curve, where shorter-dated bonds yield more than longer-dated bonds, has had a very impressive record of predicting recessions. In fact, every recession since at least 1955 has been predated by an inverted yield curve. There has only been one false positive over that period, back in the mid-1960s.

The nearby graph shows that while we don't have an inverted yield curve currently, we could be headed in that direction.

Past economic recessions have been both severe (think the Great Depression and the recession in 2008) and fairly mild (think 1990 during Desert Storm). The impact on the stock market has varied as well, but typically recessions are not good for stocks. The average monthly return for stocks since June of 1976 was just under 1.0%, but during recessionary months, it was a loss of over 0.5%. If a recession persists, a number of negative months in a row can result in nasty stock market declines.

While the yield curve should be considered, we shouldn't necessarily head for the hills. For starters, it isn't inverted yet. As you can see on the nearby graph, the 10-year Treasury

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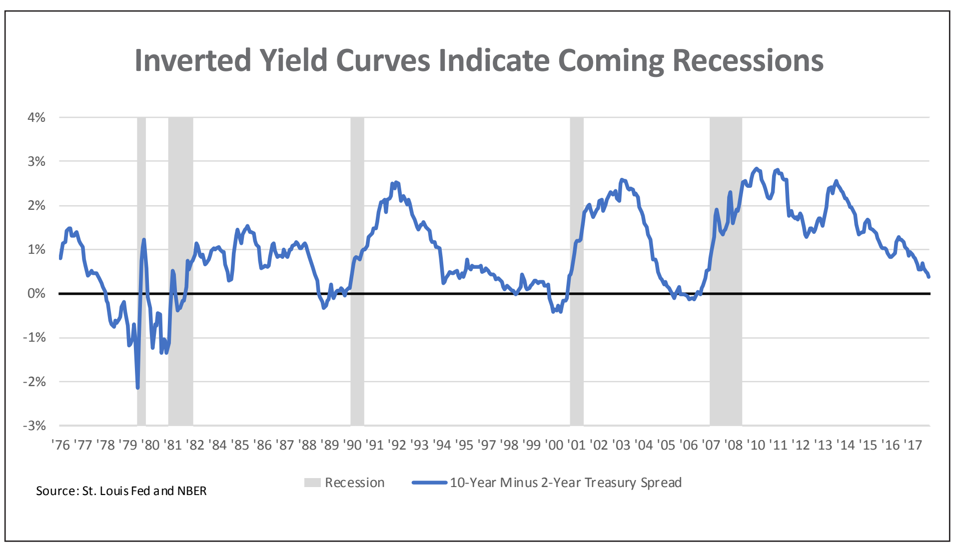


A Tale of Two Markets *continued from page 3*

yield minus the 2-year Treasury yield has been at similar levels to today's without subsequently becoming inverted. This was true throughout most of the 1990s, when stock market returns were some of the best on record.

Also, even when the yield curve inverts, it can take up to two years for the economy to show signs of recession. The economy is quite strong currently, and even if a recession is coming, there could still be a couple years of solid returns from stocks. And, if the next recession is mild, missing out on two years of stolid stock market returns to avoid modest losses won't make sense. There is no way to know in advance what will transpire, which is why we don't spend much time trying to time the market.

Finally, it may be different this time. The flat yield curve we are experiencing may be more because of government influences than any economic insight on the part of the bond market. The Fed bought trillions of dollars of securities, mostly Treasury bonds, to help stimulate the economy in the wake of the last recession. While it is starting to unwind these holdings, it still has massive holdings, which may be keeping long-term interest rates lower than they would otherwise be. At the same time, the Fed has been raising short-term interest rates. These two forces may be working to flatten, if not invert, the yield curve. If an inversion happens because of government influence rather than free market forces, it is possible we won't see a subsequent recession.

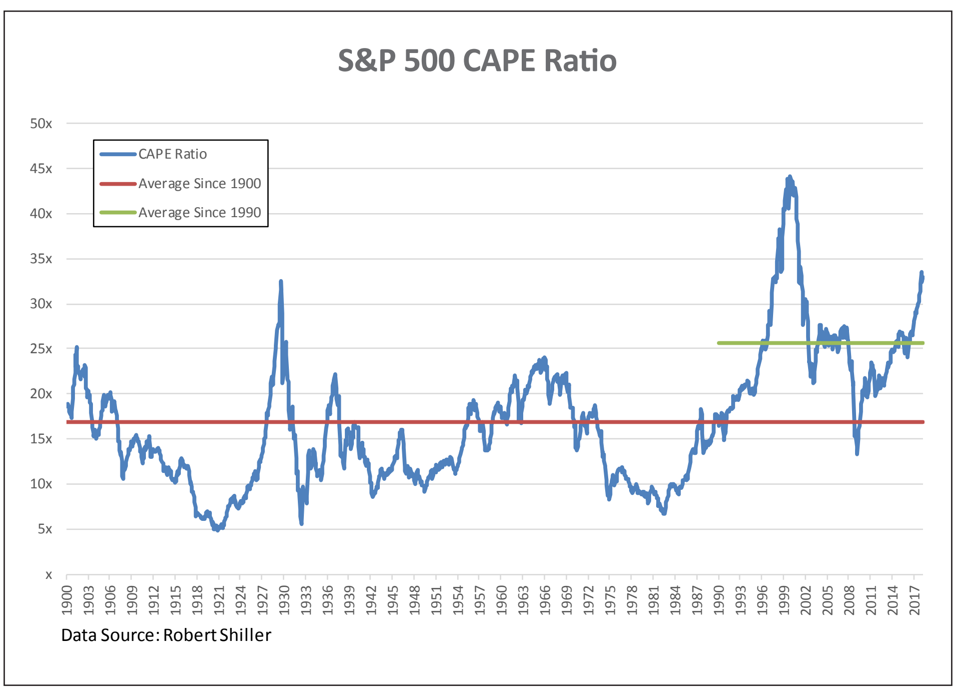
No one wants to go through another downturn like we experienced in the early 2000s or in 2008. It therefore seems reasonable to want to protect assets by becoming more conservative. However, it isn't that simple. For example, timing the market is an imprecise art, even when stocks appear overvalued and reliable indicators are flashing ominous signs. Numerous studies show that market timing is a fool's errand.

Also, selling out of stocks, particularly after a ten-year bull market, can result in quite a hefty capital gains tax bill. And, what if you're wrong about the market's future direction. Imagine trying to time the market by selling out, paying significant capital gains tax on all the earnings of the past decade, and then finding that you were wrong as the market continues to move higher. That is a real possibility in today's environment.

Besides, what seems like credible evidence to the contrary, there is still a reasonable case to be made for stocks to continue their march higher.

Robert Shiller, a Yale professor and Nobel Laureate, devised a valuation metric that has been widely adopted by the financial community and financial media. It effectively boils down to taking the price of the S&P 500 and dividing by the average earnings of S&P 500 companies over the past ten years. This is essentially the same as using the P/E ratio, but it smooths the ups and downs in valuation figures by removing short-term earnings fluctuations. Shiller calls his metric the Cyclically Adjusted Price/Earnings (CAPE) ratio.

Using the CAPE ratio, the stock market's valuation surpassed that of the 1929 peak, and recently traded at the second highest level on record (see nearby chart). The Dot Com bubble is the only period since the late 1800s where valuations were higher. This has set off a rash of speculation that the market is on a path toward a large decline.



However, Wharton professor Jeremy Siegel has shown that the CAPE ratio may overstate true market valuation because of changes in the way S&P 500 earnings have been calculated, as well as other issues.

Additionally, and a fact that we believe has largely been overlooked, now that there is a new tax regime for corporations, it may be that historical, earnings-based measures of stock market valuation are even less relevant for forward-looking purposes.

When we did our own analysis, making two simple adjustments to earnings based on these issues, we find that a reasonable case for further stock market appreciation can be made.

The first adjustment is to pick up on professor Siegel's point that S&P 500 earnings during the Great Recession were unfairly penalized by insurance company AIG. The bust in AIG effectively wiped out the earnings by every other company in the S&P 500. However, to say that the entire S&P 500 had near-zero earnings overstates reality. Siegel's "The Shiller CAPE Ratio: A New Look" published in the *Financial Analysts Journal* in 2016 presents this case in much more detail.

In order to adjust for this abnormality, and recognizing that the impact will roll out of the current CAPE calculation in roughly 18 months as the ten years' worth of earnings in the calculation rolls forward, we recalculated the current CAPE ratio, but started averaging earnings in December of 2009 rather than June of 2008. We then applied a 5% annualized growth rate to Robert Shiller's current earnings figure for the remainder of 2018 and 2019 to come up with 10 years of earnings. Bear in mind that consensus earnings forecasts are currently for close to 10% annualized growth between now and the end of 2019.

The second adjustment we made to the earnings data was to reflect the new tax law. With the corporate tax rate now at 21%, versus a previous high rate of 35%, earnings should theoretically be higher going forward. Accounts we have read speculate that aggregate corporate earnings could rise by 10%. Accordingly, to reflect this impact, we adjusted historical earnings by 10% to come up with a pro forma of what they would have been if the tax law had been consistent over the past ten years.

These adjustments reduce the CAPE ratio from today's reading of 32.1

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Compliance Corner

The SEC recently approved two new rules: (1) the adoption of new FINRA Rule 2165 (Financial Exploitation of Specified Adults) to permit members to place temporary holds on disbursements of funds or securities from the accounts of customers where there is a reasonable belief of financial exploitation of these customers; and (2) amendments to FINRA Rule 4512 (Customer Account Information) to require members to make reasonable efforts to obtain the name of and contact information for a trusted contact person for a customer's account.

While Armbruster Capital is not overseen by FINRA, any changes imposed on FINRA members, such as our custodians Charles Schwab and TD Ameritrade, tend to find their way onto our "to do" list. In this case, the rules do offer common-sense protections for older clients. Unfortunately, elder abuse and financial exploitation are growing issues.

Accordingly, we are talking with all new clients about the ability to add a "trusted contact" to their accounts. This would be someone who the custodians or our firm can contact if suspicious activity is suspected. Existing clients can also add a trusted contact to their accounts; just let us know if you would like to do so.

Ideally, the trusted contact would be a close family member or friend. This person would not have access to view or make transactions in your accounts. Rather, the trusted contact would be someone who would be able to act as your emergency contact should you become unable to manage your account, or if we are unable to reach you directly.

As always, our updated Form ADV, which describes a number of our compliance practices, is available at our web site or upon request.

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Nipa had already taken care of Nyla's hair and makeup at home. Nyla definitely looked more than a little overdone, but I was assured this would look normal on stage. One of the things I suspect dad's fear the most about dance recitals is the fact that their young daughters are made up and dressed up to look much older than their chronological age. Often there is an inappropriate, suggestive flair to the costumes and dances. We specifically chose our dance studio because it seemed to tone this down versus other schools we considered. Still, I couldn't help feeling that all the girls looked like little harlots.

The other notable issue regarding the costumes is their cost. We spent $70 on Nyla's costume, and she could use it for all three of her dances. However, I'm told the older girls are often in 15-20 dances and different costumes are required for each one. I love my daughter, but I don't know that I love her enough to buy $1,500 worth of dance costumes each year. I suspect these costumes will only ever see one wearing, making the cost all the more egregious. After all, there are more important things to spend money on, like trail grooming equipment.

We took our boys with us to the dance recital, as we feel it is important for everyone in the family to support one another. And, after we found our seats, the complaining began in earnest. "These seats are so uncomfortable". "Why did we have to get here so early?" "Why does this have to take so long?" I couldn't help it; I wanted to be home working in the yard.

Once the recital started, we were properly entertained for some time. However, I noticed in the program that there were 62 dances scheduled. I enjoyed the early part, and of course looked forward to the few numbers that included my daughter. But, I discovered that after the first 40 or so dances you go numb and start to feel like that guy in *A Clockwork Orange* when they used mechanical devices to hold his eyelids open while he watched images or war, famine, and depraved violence.

In the end, we survived the whole ordeal, though Amer did fall asleep for a significant portion of it. We left the recital around 7:30. On the plus side, the production value was quite good. The studio obviously puts a lot of time and effort into the event. And, many of the dancers were highly skilled. Besides, seeing your little princess beaming and bopping around on stage, however ungainly, makes it all worthwhile.

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times average earnings to 24.6 times earnings.

Certainly, there is a lot of room for a more thoughtful and rigorous analysis of the adjustments we propose, and there are many other factors that will impact the stock market going forward. However, there is a reasonable case to be made that stocks are not as extremely valued as most headlines suggest. In fact, if our adjustments are accurate, the stock market currently trades below its average CAPE ratio since 1990, which is 25.6.

If one assumes that today's raw CAPE ratio of 32.1 is a level at which the market could trade, and using our earnings adjustments, this implies the S&P 500 could rise to 3,550 or 30% from its current level. A rise of that magnitude is certainly not the consensus, but it is mathematically reasonable for the market to continue to earn significant gains.

The stock market often moves contrary to consensus forecasts. In the face of many stock market naysayers, there is a reasonable argument for a path toward further gains.

Truly, it is the best of times and the worst of times for stock market investors.

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