Market Update
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Investors came through a rough patch in late May and early June as the market tried to decide how much of its growth over the past few years was due to Federal Reserve intervention. Key committee members hinted that their support should not be expected to continue indefinitely, so everyone began trying to figure out how much ground the market could be expected to retrace if the Fed stopped buying bonds.

The major question that differentiated buyers from sellers earlier this summer was whether market gains have been driven by attractive fundamental asset values or Fed programs.

We believe the stock market has risen since 2009 primarily because of fundamentals. A look at the earnings backdrop tells us U.S. companies, as a group, are improving on their all-time most profitable numbers quarter-over-quarter. Earnings that have expanded faster than prices enable stocks to maintain valuations that are still attractive for investors. We expect the market to continue rising alongside earnings.

The economy, while only cruising, is making incremental improvements. This, coupled with company profitability, provides an explanation why we saw buyers step in after the May-June selloff and drive us to new highs on the S&P 500.

When we look at fundamental valuations across the entire investment portfolio, some asset classes look expensive. We detailed in a recent communication to clients that we are getting out of high yield bonds and preferred stocks because they appear expensive. Most fixed income assets look expensive in relative terms, but some of them are important to continue holding because they function as great portfolio diversifiers.

On the stock side, when we compare the most and least expensive parts of the portfolio, it small companies may be getting slightly expensive. These stocks historically pay investors a premium, and we expect them to continue outperforming their large company brethren, but it is possible they will deliver less outperformance over the remainder of this market cycle.

Globally, U.S. companies are most expensive because investors are willing to pay up to invest here. For example, a U.S. consumer staples company of the same size and selling the same goods to similar customers, currently costs more to own for each dollar of potential earnings than an equivalent European company. Why? U.S. companies are considered more stable because they have held their value a little better.

This also helps explain that while U.S. companies have delivered the best returns over the last five years, we should expect international and emerging market companies to have better returns over the next five. They are simply less expensive, which leaves more room for gains.

The U.S. vs. Europe phenomenon has been fairly consistent for most of the last 40 years. European indexes have delivered higher returns than U.S. companies over that period. The same goes for emerging market companies, which have posted considerably higher returns over the last 15 years.

Companies in these parts of the world are less expensive to own because there are outstanding questions about their ability to grow earnings in less business friendly environments or greater general uncertainty about the future. These concerns ultimately get reflected in lower stock prices.

We all see potential risks to investors on the news, especially when the camera pans out and we can see the global landscape. But those risks are priced into the market values of these companies, and they have no real bearing on their ability to generate profits. With that in mind, when evaluating portfolios today, we want to be buying these bargains.