SPRING 2018 | VOL. 25 | NO. 2
QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

THE PENDULUM SWINGS…

The market euphoria we experienced in January stemming from recent tax reform (the Tax Cuts and Jobs Act signed into law on December 22, 2017), quickly turned to pessimism as the Trump administration announced on March 1st the imposition of tariffs on steel and aluminum imports. The fear of a rapidly escalating trade war with China has caused investors to question the staying power of the synchronized global economic rebound that began in the fall of 2016. With nearly half of the earnings of the S&P 500 attributable to foreign revenues, these are legitimate concerns, but it is still not yet clear if this approach is simply a negotiating tactic or new U.S. international trade policy.

The Impact of P/E Multiple Expansion & Contraction

With earnings of the S&P 500 Index projected to climb by nearly 19% in 2018, investors are in a quandary as to how stock prices can be in swift decline while near term corporate earnings prospects appear to be so bright and positive. My response is simple: sometimes it is not so much the earnings of a company, but what an investor is willing to pay for the projected earnings. As an example, in both 2016 and 2017, as the globe was awash in central bank liquidity, investors bid up the price of U.S. common stocks. Nearly half of the % gain in the broad market was driven by a rising P/E multiple, increasing from a 17x multiple to over 20x by year end 2017. The inverse is true so far in 2018. The fear and uncertainty associated with rising interest rates, a growing U.S. deficit and recent trade war concerns have investors pulling in their horns and feeling more skeptical on full year earnings results. This is neither unusual, nor unique to 2018; it has been part of the market pricing dynamic from the very beginning. However, this we do know: over time the market price will eventually follow the direction of earnings within this fear/greed bandwidth.

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PRICE/EARNINGS MULTIPLE [EXPANSION & CONTRACTION]

	S&P 500			% Change		
Year	Price	EPS	P/E	S&P 500	EPS	P/E
'00	$1,320.28	$56.78	23.3x			
'01	$1,148.08	$47.49	24.2x	(13%)	(16%)	4%
'02	$879.82	$50.51	17.4x	(23%)	6%	(28%)
'03	$1,111.92	$55.23	20.1x	26%	9%	16%
'04	$1,211.92	$68.80	17.6x	9%	25%	(13%)
'05	$1,248.29	$78.56	15.9x	3%	14%	(10%)
'06	$1,418.30	$90.06	15.7x	14%	15%	(1%)
'07	$1,468.36	$87.45	16.8x	4%	(3%)	7%
'08	$903.25	$73.70	12.3x	(38%)	(16%)	(27%)
'09	$1,115.10	$61.95	18.0x	23%	(16%)	47%
'10	$1,257.64	$87.02	14.5x	13%	40%	(20%)
'11	$1,257.60	$98.89	12.7x	(0%)	14%	(12%)
'12	$1,426.19	$105.21	13.6x	13%	6%	7%
'13	$1,848.36	$111.29	16.6x	30%	6%	23%
'14	$2,058.90	$118.89	17.3x	11%	7%	4%
'15	$2,043.94	$118.59	17.2x	(1%)	(0%)	(0%)
'16	$2,238.83	$119.16	18.8x	10%	0%	9%
'17	$2,673.61	$133.08	20.1x	19%	12%	7%
'18*	$2,640.87	$157.78	16.7x	(1%)	19%	(17%)

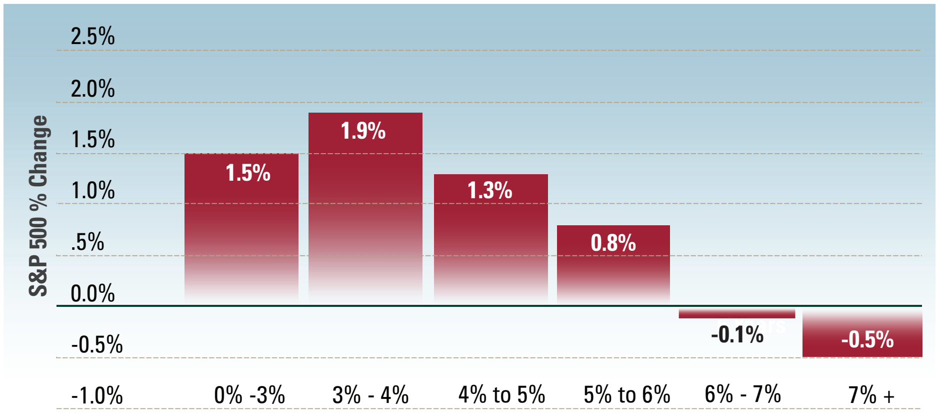
** 3/31/2018 S&P 500 Price and Consensus EPS Estimates* *Source: Factset*

Brian Christensen, CFA
Senior Vice President & CIO

STOCK PERFORMANCE IN TIMES OF RISING INTEREST RATES

Beginning in 2008, in response to the collapse of financial markets, the Federal Reserve initiated a period of extremely accommodative monetary policy. The Fed Funds target rate entered 2008 at 4.25% and finished the year at 0.25%. For more than seven years, historically low interest rates were maintained and proved to be a driver of higher prices for all types of assets. The Fed managed to assure significant liquidity was available in financial markets thus encouraging investors to assume greater risk as that was the only route to reasonable investment returns. In late 2015, the Fed signaled the end of this policy cycle by bumping the Fed Funds target rate to 0.5%. We have seen five additional increases to the Fed Funds target rate since late 2015 reaching the current level of 1.75% on March 21, 2018. While interest rates are far from excessive or stifling U.S. economic growth, the message from the Fed is clear in that the path for interest rates is higher.

MONTHLY AVERAGE CHANGE IN S&P 500 DURING PERIODS OF RISING 10-YEAR TREASURY YIELDS



10 - Year Treasury Note Yield

Source: Standard & Poor's as of December 20, 2017

So what does this mean for stock investors? History has proven that stocks can move higher in tandem with rising interest rates. However, a key issue is the initial level from which interest rate increases begin their ascent. The chart above provides a perspective on how the S&P 500 responds to increases in the 10-Year U.S. Treasury Yield.

As implied by the chart, stock prices should respond favorably to rising rates, particularly if initiated from a low base. Historically, until the 10-Year Treasury yield reaches the 6% level, stocks have been able to generate positive monthly average returns.

Digging a little deeper into the data, we identified six specific time periods when the 10-year Treasury yield was climbing.

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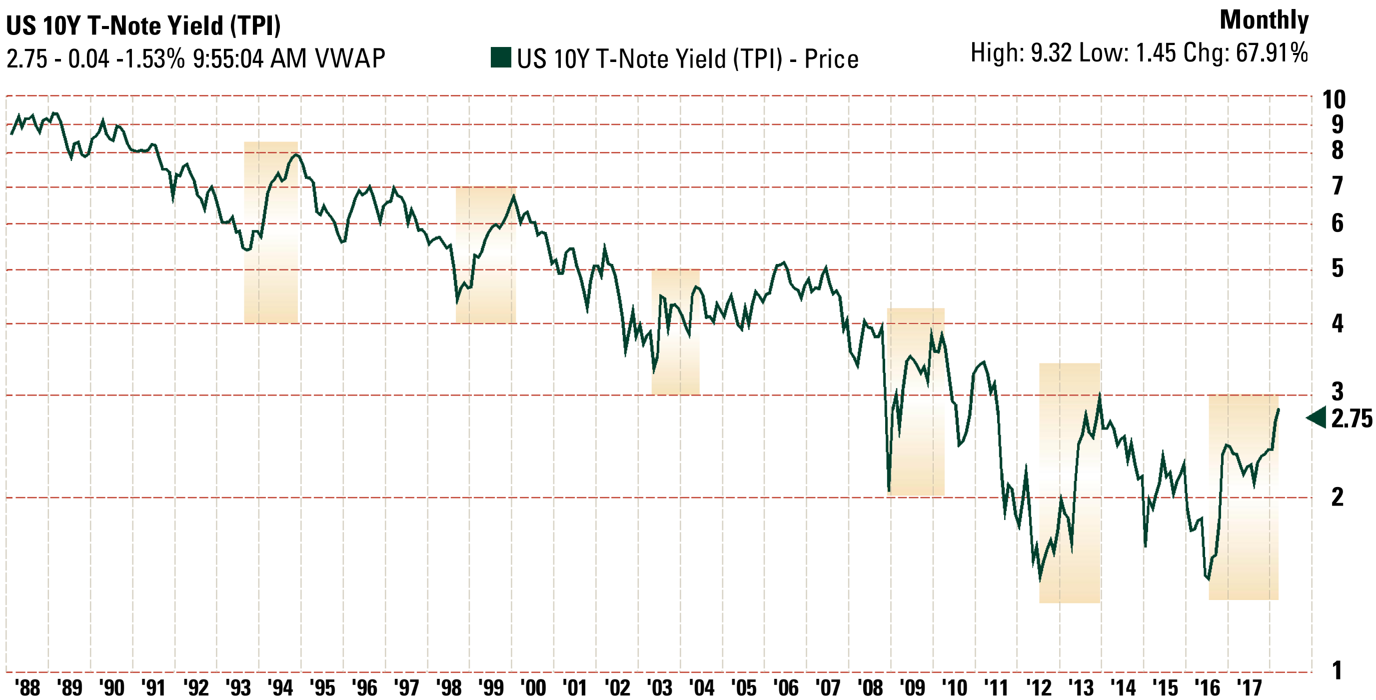

Source: FactSet

CONTINUED FROM PAGE 2 : STOCK PERFORMANCE IN TIMES OF RISING INTEREST RATES

The table on the right identifies those six windows and the respective returns for the S&P 500, S&P 500 – Dividend Payers, and large value stocks as measured by the Russell 1000 Value Index.

With the exception of the November 1998 to February 2000 timeframe (recall these dates as the Tech Stock Bubble), both Value stocks and Dividend Payers performed well relative to the broad market.

RISING RATE WINDOWS – STOCK PERFORMANCE

Index	1993	1998	2003	2009	2012	2016
Starting	11/01/93	11/01/98	07/01/03	01/01/09	08/01/12	08/01/16
Ending	01/31/95	02/29/00	07/31/04	04/30/10	12/31/13	02/28/18
S&P 500 TR USD	3.35	19.29	13.92	(6.59)	25.75	17.45
S&P 500 – Dividend Payers	4.75	(0.97)	22.40	(1.28)	30.56	14.61
Russell 1000 Value TR USD	0.66	3.01	17.81	(7.77)	27.98	12.56

Source: FactSet

The Fed Funds futures market currently indicates a 60% probability of another 0.25% rate increase in either June or August and a 42% probability of an additional 0.25% increase in either September or November. Many economists are predicting a total of four increases in 2018 which would suggest possible raises in June, September and December. Moderate, well communicated increases in interest rates should be tolerated by equity markets. Despite what appears to be a return to more normal market volatility, we believe the underlying strength in the U.S. economy and continued growth in corporate earnings will provide the basis for improving stock prices.

MIKE FLAHERTY, *Relationship Manager*

In February, Mike Flaherty joined the firm as the newest Relationship Manager in the Peoria, IL office. Mike brings to DVI over 15 years of experience in the financial service and insurance industries, where, as a financial advisor and operations manager, he proved himself as an effective leader. He is also experienced in financial planning and insurance solutions.

Mike is a graduate of Illinois State University where he received his Bachelor's of Science degree in Insurance. He is a Certified Financial Planner®, a Chartered Financial Consultant and a Chartered Life Underwriter. Additionally, he has held the FINRA Series 7 and 63 securities licenses and a Producer's License in Life, Health, Property, Casualty, and Variable Contracts.

As a relationship manager at DVI, Mike's responsibilities will include the oversight and coordination of the delivery of the DVI Service Model to our clients. In addition, Mike will introduce ancillary services to clients that will enhance their overall experience with DVI.

Mike is also an active member of his community, serving on the board of directors for the Boys & Girls Club of Bloomington-Normal and previously as an Ambassador for the McLean County Chamber of Commerce.

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Bear Market Downturns

After a prolonged Bull Market, some say the current rally is "long in the tooth," so there is a natural tendency to expect a significant market decline. Year-to-date in 2018, we have experienced a market correction—a decline from the prior peak of at least ten percent. A Bear Market, however, is defined by a market decline of twenty percent or more.

Research would suggest that in the modern economic era, significant market downturns are generally associated with recessions caused by (1) over aggressive Fed Policy or (2) a commodity price spike in crude oil. The other prominent factors are market speculation and extreme valuation applied to certain economic sectors or to the market as a whole.

As we assess the current state, we certainly have a rising interest rate environment, though the Fed has been very incremental and transparent in its execution. Market speculation is present in a handful of well known technology companies that have provided growth stock leadership over the past 15 months or so, but that is not widespread. The economic forecasts continue to maintain a 2.5% or greater GDP growth rate for 2018 with both tax reform and fiscal policy supporting the U.S. economic engine. For the time being, it is hard to anticipate the market falling off a cliff with this as the economic backdrop.

		Macro Environment			
Modern Era - Bear Market Downturns	**Market Peak**	**Recession**	**Commodity Spike**	**Fed Policy**	**Extreme Valuation**
Flash Crash 1962 - Cuban Missile Crisis	Dec-61				■
Tech Crash of 1970	Nov-68	■	■	■	
Stagflation - OPEC Oil Embargo	Jan-73	■	■		
(Volcker) FED Tightening	Nov-80	■	■	■	
1987 Crash - Portfolio Insurance	Aug-87				■
1990 - Iraq invades Kuwait	Jul-90	■	■	■	
Dot.com (Boom and Bust)	Mar-00	■			■
Global Financial Crisis	Oct-07	■	■	■	

Source: JP Morgan, National Bureau of Economic Research

FROM WHICH ACCOUNT SHOULD I PAY MY IRA FEES?

This is a question we are receiving frequently after the passage of the Tax Cuts and Jobs Act in December 2017. With investment management fees no longer eligible as a miscellaneous itemized deduction, does it still make sense to have IRA fees collected from a taxable account, or should those fees now be collected from the IRA?

When the IRA investment management fee was fully deductible when paid with outside dollars, it was pretty clear cut that it was best to pay this fee from a taxable account and allow the IRA dollars continued tax deferred growth. Now that investment advisory fees are not deductible, is this still the case? If the fee continues to be collected from a taxable portfolio, the upside remains in that those retained dollars in the IRA account continue to compound and grow tax free. However, there also is upside to collecting fees from the IRA as well, in that this payment is being made on a pre-tax basis. So which upside should you choose?

Tax deferred compounding can ultimately surpass the benefit of the tax deduction, but this could take anywhere from 20 to 40 years, depending on both tax and growth rate assumptions. This means that clients with very long time horizons are likely better off to pay the IRA fee with outside dollars. For clients with a shorter time horizon (such as current retirees), it is likely best to deduct the fee directly from the IRA account to get the full pre-tax value.

CANDACE FORREST, *Client Services Associate*

DVI is pleased to welcome Candace Forrest as our new Client Services Associate in the Winter Park, FL office. Candace is a graduate of the University of Central Florida with a Bachelors in Finance. With over 10 years of experience, she has assembled a broad set of skills in the wealth management industry. Prior to joining DVI, Candace worked as a Senior Client Solutions Specialist at PNC Wealth Management where she earned numerous awards in recognition of her achievements and outstanding service.

As a Client Services Associate, Candace provides support to the Winter Park Advisory Team and is responsible for assisting with our clients' daily service needs, including client documentation, new account setups, asset transfers and cash management requests. In addition, she handles the front desk and office administration in our Winter Park Office: greeting clients and setting up for client meetings.

Candace and her husband Danny stay busy with their son and daughter, Dylan and Ella, and you can often find them outdoors doing something water related such as going to the beach or boating on the lake with their family. They also enjoy taking their kids to visit Walt Disney World where they hold annual passes.