

July 25, 2017

Disruptive Change – The Source of Economic Growth

When Albion Financial Group began in 1982 the oil shocks of the 1970's were still a fresh memory. It was those shocks, combined with poor quality control in Detroit that gave foreign auto manufacturers, particularly Japanese companies, inroads into the U.S. auto market. They began by selling low cost fuel efficient vehicles without the many bells and whistles common on domestic cars and quickly garnered a reputation for quality and fuel efficiency. Over the years they moved up market to higher performance luxury vehicles.

For years many companies were working on ways to store information digitally in a portable format and the 1981 development by the Sharp Corporation of a mass-producible semiconductor laser made such storage and retrieval possible. Thus began the age of the Compact Disc (CD). In 1983, the first year of adoption, 30,000 players and 800,000 CD's were sold. The CD companies faced challenges; an installed base of analog players (better known as record players), the huge fixed investment in vinyl records of music aficionados, the lack of CD recordings compared to vinyl, and the greater cost. Yet the quality of the recording was arguably better, and with the development of the Sony Discman and automobile CD players the CD format could go where records never would. Over the following years as volumes expanded and prices dropped CD's took over.

Examples of disruption abound from Albion's thirty-five years in business; Digital cameras wiped out silver halide film, OSB board has taken a large share of the plywood market, LED's have all but eradicated traditional light bulbs, fuel injectors have eliminated carburetors in our automotive fleet, many of us have given up our land line in favor of cell phones, and slide rules are now museum pieces. And of course iTunes, Spotify, and scores of other delivery

systems have ended the reign of the CD while both U.S. and non-U.S. automakers are manufacturing and selling all over the globe.

Today we anticipate self-driving cars, distributed energy networks with less carbon fuel in the mix, cheaper artificial intelligence powered medical diagnostic capacity, and ever more powerful technology in our pockets and on our wrists. Yet there is resistance to the accelerating pace of change. Many citizens have watched these advancements and decided that on balance the changes have not helped them. Job elimination, stagnant wages, stratification of communities by income bracket, and no vision of what might make it better have resulted in a populist backlash around the world.

The collision of accelerating technological change and broad based dissatisfaction with the dislocations caused by such change is a defining trend of our time. While we are certain disruptive technologies will continue to impact society at an accelerating pace we are well aware that there will be bumps along the road. Citizens around the world are pushing back, at present primarily through the ballot box, at the inequities they perceive the current paradigm has created. It will likely take several painful iterations to come up with a political process to negotiate this minefield. In the meantime we see a dynamic economic environment with continuous evolution of products and services as individuals, companies and industries work hard each day to stay at the top of their game. At Albion we invest in companies, industries, and markets that we believe will help drive the economy forward and be generators of wealth over the coming years.

Economy & Markets

Aggregate data in the second quarter remained broadly supportive of both economic expansion and a healthy stock market. The job market continues to thrive, balance sheets are strong, confidence is buoyant, inflation and interest rates remain muted, and monetary policy is still loose – albeit decisively on the path toward normalizing.

And while the daily fixation with U.S. politics has not gone away in the 24-hour news cycle, financial market sensitivity to such noise has dampened. Not that we mind; a market more focused on the fundamentals – i.e., real economic data and corporate results – is a more attractive and rational market.

Global economic growth continues to trend up. As we mentioned in our last quarterly missive, a synchronized global economic bounce appears to be taking place. In fact, it's the first time in the contemporary recovery where we've experienced the majority of the world's largest economic horses all pulling in the same direction. Europe's economic footing has improved, so much so that the European Central Bank is finally beginning to entertain gradually removing extraordinary monetary stimulus; Japanese manufacturing is perking up and its economy seems to be in a moderate recovery; and China is ... well ... China, growing output around +6% with a government ready to turn the economic dials in either direction if required. Save for an unanticipated exogenous shock, the world economy looks as if it's in decent shape.

S&P 500 profit growth accelerated further in the first quarter (the most recent data available), and is expected to continue to rise throughout 2017. The +13.7% earnings growth rate logged in the first quarter was the best pace since 2011. It also marks the third straight quarter of *accelerating* profit growth. Despite all the bullish conversation around the potential for fiscal stimulus, it's this profit growth in our view that has been the real driver of stock returns this year. Indeed, we remain dogged in our position that corporate profits do the heavy lifting with regards to stock prices. That said we do not anticipate earnings growth to continue its current energetic stride. Rather we believe that while the upward trajectory should stay intact, it will likely be closer to a normalized mid-single digit speed.

Equity valuations remain neither cheap nor expensive, in our view. Nevertheless it seems rare to find anyone who doesn't think that stocks are too high or richly priced. This is likely a good contrarian indicator, and tells us a lot about the current state of the market. We both recognize and are attuned to the metrics that the bears point to suggesting an overvalued market. But there are many other metrics that show no such excess. When viewed comprehensively we continue to assert that valuations are sensible, particularly considering low interest rates, tepid inflation, and improved earnings growth.

Despite another rate hike of 0.25% in June monetary policy remains rather loose. And for the third time since December financial markets took the hike in stride as the collective belief has been that the Fed is raising rates for the "right reason" – that is, the general economy is fit and warrants such action. Under our baseline assumption that the U.S. economic expansion perseveres we think that the Fed is likely on the path towards further policy normalization, although perhaps at this point focusing more on reducing the size of their large balance sheet versus raising the Fed Funds rate. If correct, this policy shift could ultimately have a more direct impact (upward pressure) on longer-term interest rates.

Planners' Corner

Social Security planning is an important part of your retirement plan. Yes, it's true that understanding all your available options is complex, but taking the time to evaluate them is worthwhile. Why is this the case? For some the value of their Social Security payments can add up to more than \$1,000,000.

If you were born before 1954, you still have the option to restrict the scope of your Social Security benefit to a spousal benefit. Doing this allows your own benefit to earn the 8% annual delayed retirement credits while you take a spousal benefit based on your spouse's

earnings. The strategy can add thousands of dollars in extra benefits to you over your lifetime.

There are also unique benefit options for divorced and widowed applicants. With the above in mind, if one of these situations applies to you and we haven't run a Social Security analysis for you, please let us know. Also, if you know someone who would benefit from a Social Security analysis, please refer them to us so we can help them strategize their benefit options.

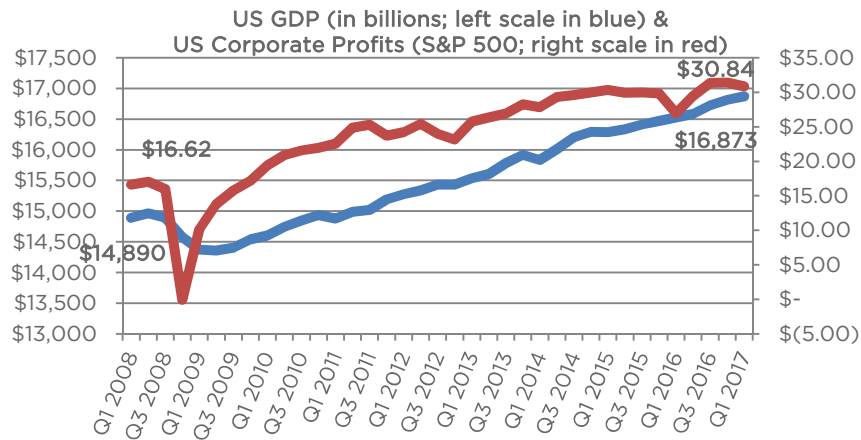
Albion Community

One of the unique things about Albion Financial Group that sets us apart from our competitors is our team approach. This quarter we want to highlight two members of our team, Dana Pool and Michelle Buxton, who just graduated from the University of Utah. Dana earned her MBA and Michelle completed her BS with degrees in Human Development and Consumer & Community Studies with an

emphasis in Financial Planning. Supporting educational development is very important at Albion and we are delighted to share this news with our clients and friends. In addition to earning her degrees, Michelle is Albion's newest Senior Wealth Advisor. Congratulations Dana and Michelle!

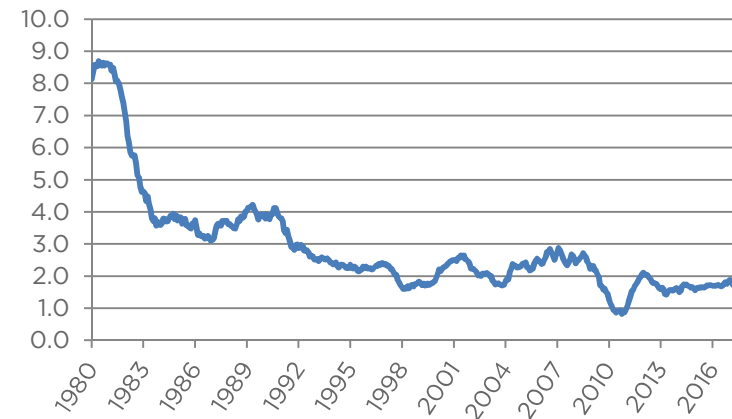
We also want to announce that Albion Financial Group has been recognized as the 2017 Best of State winner in two categories: Investment Advisory Services and Retirement Planning. Our unique service offering pairing investment management with financial planning, our fiduciary standard and fee-only structure, as well as our active community involvement were all aspects that the Best of State judges considered in recognizing Albion for this prestigious award. If you have family, friends, or colleagues who may find value in learning more about Albion's award-winning service, please let us know. We would be pleased to provide them with a complimentary advising session. Your referrals are an important part of our business and the highest professional praise we receive.

UNITED STATES GDP ANNUAL GROWTH RATE



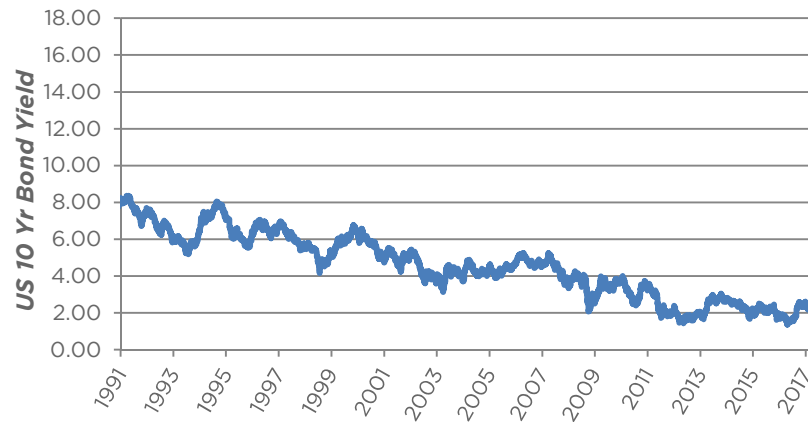
Slow and steady economic growth persists and S&P 500 corporate profits continued to expand after a lackluster 2016. In Q1 2017 broad-based earnings logged the strongest growth pace since 2011. The general economic data – output, labor market, and confidence – are encouraging.

UNITED STATES INFLATION RATE



Inflation remains tame by most measures with the most recent data showing a rate slightly below the Fed's 2% target. We continue to monitor strengthening wage growth which could push up inflation over the longer-run. At present price growth remains in check.

US 10 YEAR TREASURY YIELD



Post-election, both short and long interest rates have risen by a moderate amount. In June the Fed hiked their target rate an additional 0.25%, the fourth such hike since December 2015. The Fed may pause their pace of short-term hikes for now as their focus has clearly pivoted to reducing the size of their large balance sheet which could cause longer yields to gradually rise. Nonetheless, interest rates remain very low especially in the context of history.

TRAILING 12M P/E RATIO: 10 YEAR



Valuation on the stock market (on a nominal basis) is not cheap. Based on forward looking profits the S&P 500 trades at a noticeable premium to its longer-run average. Yet in the context of tame inflation and low interest rates stock market valuation becomes much more sensible, particularly in light of recharged earnings growth. It's also important to note that bull markets rarely end simply because stocks are believed to be overvalued.