ALBION FINANCIAL GROUP

January 30, 2019

Happy New Year! In this edition of our quarterly letter our President, John Bird, shares his thoughts on the progress of Artificial Intelligence and the impacts we see in the wealth management world. Our Chief Investment Officer, Jason Ware, takes a look at the markets and the economy in the context of Albion's Four Pillars and in Planners' Corner our Senior Wealth Advisor, Liz Bernhard, highlights the benefits of tidying up your finances as a way to get organized for the new year. We also take a moment to highlight our 2018 national media success in Albion Community.

As we march forward in 2019 we want to thank our clients and friends of the firm. We realize and appreciate how lucky we are to work with you and your families.

Sincerely,
The Albion Team

"I have a call me chicken for you"

What?
A few days ago James Comey was in town and due to a last minute cancellation I had a spare ticket. I texted a friend, using Siri to transcribe spoken language. Somehow "I have a Comey ticket for you" became a nonsensical quote about a chicken. Voice recognition and transcription may be the most conscious interaction we have with a broad array of technologies lumped together under the name Artificial Intelligence (AI).

The promise of AI is broad and deep. Vastly improved medical diagnostics, efficiency in energy use, self-driving cars, and increased cybersecurity are just a few of the areas where the technology is being applied.

But what is AI and how does it compare to human thought? And why did Siri think that I wanted to tell a friend about a chicken?

John Launchbury, a Defense Advanced Research Projects Agency scientist, uses a three wave framework to help us understand the evolution of AI.

In the first wave, handcrafted knowledge was converted to a set of rules. It is this capacity that made software tools like TurboTax, chess games, and business logistics applications successful. A machine can be programmed with a series of rules and will then apply those rules to the data it receives. These systems can reason within the defined rule set but have no learning capability and are poor handlers of uncertainty. Even with these limitations it is a relevant technology that is in widespread use.

The second wave systems involve statistical learning, which requires processing a massive amount of data, discerning patterns that repeat, and using those patterns to "learn". The success of a supercomputer in beating chess Grand Masters is based on this notion. The supercomputer has access to a database of decades and decades of chess games. For any board position it can rapidly review every previous game where the players encountered an identical board position and review each of the successive moves made in those games to determine an optimal course of action. This type of "learning" is being applied across scores of fields, from business, to medicine to education. It is the Big Data approach and does help tease insights out of information that might not otherwise be apparent. While these systems have a much improved ability to perceive the natural world, for example separating one face from

another, they have limited reasoning capacity and have almost no capacity for abstract analysis.

The third wave is the ability to create contextual adaptation which is a work in progress. As humans we know that context is everything. If I use the word “sick” when visiting the doctor it has an entirely different meaning than when my teenager uses it in the context of catching big air on skis – and AI would have no idea what “catching big air” meant either.

AI takes a mathematical process and attempts to model human thought. At present it views text as data, not language, which due to the underlying mathematics of all computer systems is not surprising yet is an issue researchers across the globe are working to overcome. Without an awareness of context such systems run the risk of extrapolating trends beyond what most humans would consider reasonable.

A team of researchers created an AI algorithm that was to resemble a nineteen year old female twitter user. The AI personality learned from its twitter interactions and over time became more and more inappropriate as it extrapolated and accelerated the trend of ever more edgy and offensive commentary. Other efforts to create human type interaction AI programs have had the same experience. The “learning” takes these algorithms in a direction that is highly focused and to most humans ultimately unacceptable.

Many observers have shared their perspective that AI is unlikely to consciously choose to overwhelm their human creators. Rather AI will take their algorithmic learning in a direction far out of line with human norms. We should be less worried about Arnold Schwarzenegger’s Terminator threatening our existence as we should about AI misinterpreting human instructions due to a lack of context.

The wealth management world has and continues to experience every one of these waves with new advice algorithms rolled out regularly. Yet more and more families are turning away from online tools, recognizing that they do not and cannot capture the context of their lives. Further, we are seeing the growth of Robo investment accounts – tools where the investor answers a few short questions and an investment portfolio is created and managed for them - taper off. It’s not that these tools are bad. It’s that they are mathematics attempting to model, understand, and act on the complex activity that is human thought.

Over the last few decades AI has created excellent tools, many of which we use in our day to day efforts. However we remain aware of AI’s blind spots. Information is not knowledge and knowledge is not wisdom. We will continue to use the best of what AI has to offer, but only in the context of the essential value we add through deep relationships that bring the experience and wisdom of human understanding to bear on each of our clients’ lives.

Economy & Markets

The U.S. economy in the fourth quarter continued along its path of expansion. Broadly observed, employment measures are good, aggregate consumption is strong, companies are healthy, and overall confidence looks encouraging. Meanwhile, core inflation data suggests a balanced and modest general price level. This backdrop has helped support corporate revenues pushing profits to record highs. Indeed, in the most recent reporting period earnings growth expanded, yet again, at a very impressive +25% clip on a year-over-year basis. Nevertheless we remain ardent in saying that this gait cannot be maintained over the long-run. At some point, likely in the near future, we expect it to revert to the historical mean settling in at a mid-to-upper single digit pace. We’ve qualified this view in previous letters by stipulating that we are not trying to sound

alarmist when sharing this. Rather it's a simple recognition of fact in an effort to more properly align, perhaps even contain, investor expectations.

The global economy, despite a trade war festooned with ugly, risky bombastic statements, appears to be going fairly well. Admittedly this is a sanguine tone, though we do not believe that we're whistling past the graveyard. Quite the contrary – we are carefully watching international trade developments. Yet as we've repeatedly made clear, we claim no edge in prediction on this or any economic matter. So we watch and we wait. Just like everybody else. This is part and parcel of the process in trying to find the investment signal amid the noise, while making the best decisions possible through this work. And from our perch, to-date, the various trade skirmishes have had only a minor impact. This makes sense given basic logic holds that a self-inflicted true economic 'dance of death' is in no country's best interests. Consequently, our best *guess* is that cooler heads will ultimately prevail. Speaking of unforced policy errors, we recently endured a government shutdown. The situation captured news headlines, promoted political bickering and finger pointing, and offered scores of viral soundbites. However it did not provide a compelling reason to sit on the sidelines and not be invested for the long-term.

In December the Fed raised interest rates for the fourth time in 2018. After nine such rate hikes since 2015, financial participants and pundits alike endure in debating the question of whether or not the central bank is flying on autopilot at this point and will therefore ham-handedly push rates too far too fast at the expense of economic growth and stock returns. And as per usual, the parlor game among the Wall Street pack of "*how many times will they hike?*" has turned their collective sight toward 2019. Regrettably we have no special superpowers here – we simply don't know what the Fed will do in the New Year. But what we *can* say is that for now rates are low when viewed through the context of history. This setting continues to be favorable for both the economy and for stocks. That said rising rates, among other factors, can surely lead to increased stock market volatility even if the overall trend is higher. The optimist's take on higher rates is that they provide more current income from cash instruments and other fixed-income securities. Touché. All told, we think it reasonable to welcome gradually rising rates if it's in accordance with an improving and dynamic private sector.

Fair warning … what follows is something you won't hear from many investors in the current environment. So here goes. Valuation on the stock market is now *cheap*. That's right – we said it. Cheap. The drop in stocks at the end of 2018 alongside relatively unchanged (and above-described) fundamentals has left the market trading at approximately 14x forward S&P 500 earnings. Plotted alongside a growing economy, rising profits, low borrowing costs, and tepid inflation, stocks at current levels look quite attractive for long-term investors. The caveat however is that we must be patient and returns won't be in a straight line. To be sure the deferred gratification gene can be a tough one to summon, particularly in times like these when our investments exemplify wild behavior. But, as Napoleon Hill noted over 70 years ago: "*patience, persistence, and perspiration make an unbeatable combination for success.*" Works for investing, too.

Our preferred *'four pillars'* framework of *economic & earnings growth, inflation, Interest rates, and valuation* tells us that the present condition for equities, notwithstanding the recent and swift bear roar, remains promising. Save for a sudden economic recession, which we don't presently anticipate, we think stocks can weather what we consider to be little more than changing market narratives. Nevertheless this opinion should not be confused with a near-term market call. Prices can certainly decouple from fundamentals. The inherently unpredictable psychology and mood of the crowd is indisputably what drives stocks over the short-run. Never forget that

falling prices attract sellers, and rising prices attract buyers. Fear and volatility cluster. It's that simple. We understand this and thus do not wish to forecast these impulses. Instead, we consider the *four pillars* as objective tools to assess the investing landscape in an attempt to evaluate equity returns over time. And as such, our core philosophy that finding and owning slices of great American *businesses* via long-term investment in stocks is a wise proposition when trying to grow wealth in the years to come.

Planners' Corner - The Art of Tidying Up your Finances

Unless you've been living under a rock lately, you probably heard about a new show on Netflix called "Tidying Up With Marie Kondo." The show is based on Kondo's best-selling book, *The Life-Changing Magic of Tidying Up: The Japanese Art of Decluttering and Organizing*. Using her trademarked KonMari Method, Kondo helps people declutter their lives by focusing on things that bring them joy while having gratitude for what they let go. Given our busy and evermore cluttered lives, it's no wonder Kondo's show is so popular.

Getting organized can have profound effects on our lives yet it can be so hard for us to do without help. Enter Albion. Marie Kondo can help with closets, but Albion can help with your financial life. Often clients come to us unsure of their overall financial picture. They have accounts all over the place - some more familiar than others. And, they don't have one place they can go to view their overall financial picture. Their financial life feels cluttered and they don't know how to start to get organized.

Albion can help consolidate accounts so that your overall investment portfolio is cohesive and in-line with your goals. We can also help you automate savings strategies, organize important documents, and most importantly, come up with a plan to reach your goals. Through our Albion Guided Planning Services tool, you can view your financial life in one place. The beginning of the year is a great time to start. Getting financially organized helps reduce stress and allows you to spend more time on the things that spark joy in your life. Please give us a call to learn more about how we can help.

Albion Community

We are very proud of the esteemed recognition Albion has received since our humble begins in 1982. And thanks to Jason Ware, our Chief Investment Officer, the past 8 years has seen a dramatic rise in our press exposure at the national level – with 2018 being our best year yet! Last year Jason was featured in national media outlets exactly 100 times. This includes appearances on PBS's *Nightly Business Report*, CNBC, The Wall Street Journal, USA Today, and the LA Times, just to name a few. In addition Jason made his first appearance in May on Cheddar TV, a live streaming financial news network, and went on to do more than 20 Cheddar appearances last year. For those of you who have spoken with Jason over the years this may come as no surprise. He always has thoughtful and insightful commentary to share regarding what is happening in the markets, the economy, and investing.

You can see Jason's appearances and read his many article contributions by visiting Albion's Press Room webpage.

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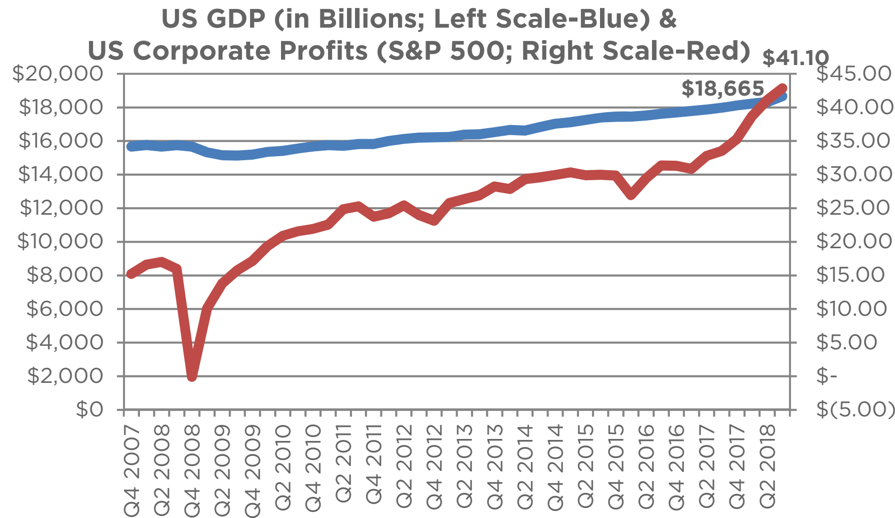
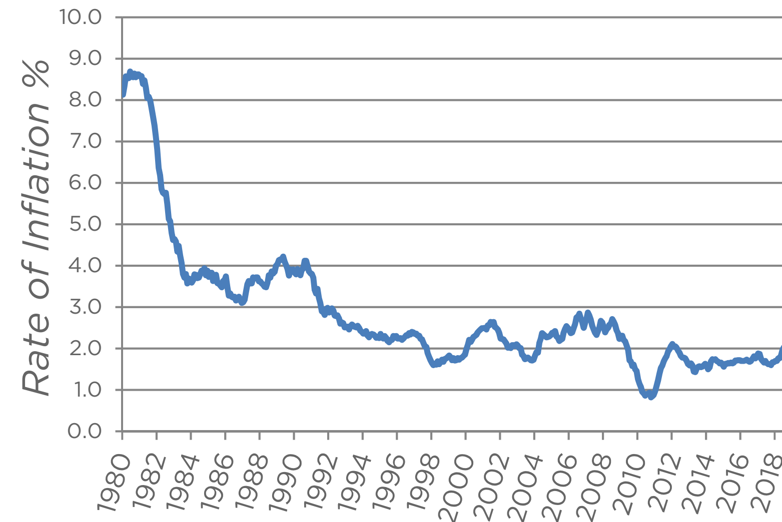
UNITED STATES GDP ANNUAL GROWTH RATE



Despite recent disquiet over the possibility of a looming recession (sentiment primarily fueled by lower equity markets), broad measures of economic data including high quality leading indicators do not point to high odds of an economic downturn. Rather, the preponderance of general data suggest a well-balanced, modestly expanding economy. While recent tax cuts likely added a mild short-term boost to output in 2018, this will soon run-off. Concurrently, trade tension with China - if left unresolved - could ultimately offset gains in these areas and negatively impact economic growth.

UNITED STATES INFLATION RATE



Using the Fed's preferred measure core inflation remains in-check with the most recent data showing a pace right around the Fed's 2% target. Additional measures like CPI and "5-year, 5-year forward" data also reflect stable, modest price growth. We continue to carefully monitor the pace of inflation. For now, our assessment remains that inflation is unlikely to run 'hot' anytime soon.

UNITED STATES 10 YEAR TREASURY YIELD

In December the Fed hiked their target rate an additional 0.25%, the ninth such hike since late-2015. Investors are closely watching the path of Fed rate hikes in 2019, and so will we. Meanwhile, the central bank continues to reduce the size of their large balance sheet allowing mature Treasury bonds to “run-off” without replacing them. Our thinking has been, and continues to be, that this behavior should – all things equal – result in longer-term yields gradually rising. This won’t be in a straight line however as evidenced by the recent drop in the 10-year Treasury yield from 3.2% in September to approximately 2.7% now. In either case interest rates remain low, particularly in real terms, which should be a positive for both stocks and the economy.

TRAILING 12M P/E RATIO: 10 YEAR

The recent sell-off in stocks juxtaposed with still-expanding corporate earnings has left the S&P 500 priced at just over 14x forward earnings, the lowest valuation since mid-2013 and below both the 5- and 10-year average. At these levels we reason that the P/E on the stock market is likely undervalued relative to the above-described fundamentals.